92-1427

Supreme Court, U.S.
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NO. _____

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1992

INDIANA NATIONAL CORPORATION
AND ITS SUBSIDIARIES: INDIANA
NATIONAL BANK, et al.,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED

Were the Taxpayers' 1970 and 1967 income tax claims for refund timely filed under the plain meaning of 26 U.S.C. Section 6511(d)(1) which contains a special seven year period of limitations applicable to net operating loss carrybacks which involve bad debt deductions?

In other words, is there any language in Section 6511(d)(1) or in the legislative history of Congress that permits the Government to avoid the plain meaning of the statute relied upon by the taxpayers and to interpret Section 6511(d)(1) as requiring that the bad debt deduction be "newly discovered or increased" for the special seven year period of limitations to be applicable?

LIST OF PARTIES

Petitioners:

Indiana National Corporation (NBD Indiana, Inc. by reason of merger October 15, 1992, formerly INB Financial Corporation) and its subsidiaries: Indiana National Bank (INB National Bank), Indiana Realty, Inc., Indiana National Network Corp., Indiana Mortgage Corp. (INB Mortgage Corp.), Consumer Marketing Services, Inc., Tower Agency, Inc. (INB Credit Insurance Agency, Inc.), Indiana National Overseas Corp., TFAC, Indiana National Leasing, Inc. (INB Leasing, Inc.) and Citadel Finance, Inc.

Respondent:

United States of America

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The petitioners, Indiana National Corporation and its subsidiaries Indiana National Bank, et al. ("Taxpayers"), respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit, which affirmed the judgment of the District Court in this case.

OPINIONS BELOW

The opinion of the Seventh Circuit is reported at 980 F.2d 1098 and is reprinted in the Appendix I separately filed herewith at A-1. The opinion of the District Court is reported at 775 F.Supp. 281 and is reprinted in the Appendix II separately filed herewith at A-25.

JURISDICTION

The judgment of the Seventh Circuit was entered on November 30,

1992. The jurisdiction of this Court to review the judgment in question by writ of certiorari is invoked under 28 U.S.C. Section 1254.

STATUTES AND REGULATIONS

Section 6511(d)(1) of the Internal Revenue Code ("Code"), 26 U.S.C. §6511(d)(1) containing the seven year bad debt period of limitations as in effect in 1973 is set forth in full in Appendix X. With respect to Section 6511(d)(1), the pertinent Treasury Regulations Section 301.6511(d)-1(a)(2) is set forth in full in Appendix XIII.

Other provisions of the Code Section 6511(d)(2)(A) and Section 6511(d)(4)(A) cited by the respondent, United States of America, regarding general rules for filing claims for refund involving a net operating loss

("NOL") carryback and an investment tax credit ("ITC") carryback, respectively, in which bad debt deductions are not referred to, are set forth in full in the Appendix XI and Appendix XII respectively.

STATEMENT OF THE CASE

A. Material Facts

The following facts based on the Complaint filed in the District Court (Appendix IV) and on the Affidavit of Charles E. Husman, Vice President and Tax Manager of INC stipulated by the Government for purposes of the Government's motion (Appendix V) are undisputed.

The Taxpayers are affiliated corporations in the banking and lending area that filed consolidated Form 1120 income tax returns with the Internal Revenue Service ("IRS").

The subsidiary Indiana National Bank of Indianapolis timely filed in 1968 its Form 1120 corporate income tax return for 1967 with the IRS. In 1971 the IRS, sent the Indiana National Bank of Indianapolis a 30-day letter containing income tax examination changes for 1967 proposed by a revenue agent which were agreed to including a decrease in its bad debt deductions of $56,690.61. Taxpayers in 1971 timely filed their Form 1120 corporate income tax return for 1970.

Taxpayers in 1974 timely filed their Form 1120, corporate income tax return for 1973, claiming a net operating loss of $4,125,569 and bad debts of $6,038,574 as follows:

	Bad Debts
Indiana National Bank	$5,894,396
Indiana Mortgage Corp.	$103,294
Consumer Marketing Service, Inc.	$35,000

TFAC, Inc.	$2,718
Citadel Finance, Inc.	$3,167

Absent the bad debt deductions claimed of $6,038,574, there would have been no net operating loss for 1973. On December 31, 1974, the Taxpayers filed with the IRS Form 1120X amended return for the calendar year 1973 amending, among other things, a bad debt deduction which was reduced by the amount of $162,218 "to agree with the 1972 Revenue Agents Report in progress."

On September 15, 1977, Taxpayers (having previously on December 31, 1974 filed a Form 1139 Corporation Application for Tentative Refund From Carryback of the Net Operating Loss . . . for 1970 in the amount of $976,764) filed a Form 1120X amended corporate income tax return for the year 1970 carrying back the net operating loss from 1973 per the Form

1120X filed September 15, 1977, in the amount of $4,098,674 from the calendar year 1973 generating the $1,008,274 claim for refund of 1970 corporate income tax.

On September 15, 1977, Taxpayers (having previously on December 31, 1974 filed a Form 1139 Corporate Application for Tentative Refund From Carryback of . . . Unused Investment Credit . . . for 1967 in the amount of $971,297) filed a Form 1120X for the calendar year 1967 showing a recomputation of the tax to reflect an investment credit carryback from 1970 to 1967 as a result of the net operating loss carryback from 1973 to 1970 generating the $862,466 claim for refund of 1967 corporate income tax.

On July 18, 1979, IRS sent Taxpayers a 30-day letter containing

the proposed income tax examination changes covering the Taxpayers' years 1967, 1970, 1973 and 1974. This letter proposed overpayments for 1967, 1970 and 1973 in the respective amounts of $671,761, $802,344 and $20,918, and a deficiency for 1974 in the amount of $92,863. Among the subsidiary changes proposed in the IRS letter were Indiana National Bank decreases in bad debt deduction in the amount of $135,464 for 1973 and increases in bad debt deductions of $10,216 for 1974; Indiana Mortgage Corporation for 1973 and 1974 decreases in bad debt deduction in the respective amounts of $103,294 and $35,945; and T.F.A.C., Inc. for 1974 decreases in bad debt deduction in the amount of $122,183. On November 16, 1979, Taxpayers filed a protest to the July 18, 1979 30-day letter of the IRS

with regard to bad debt deductions of Indiana Mortgage Corporation for 1973 and 1974 in the respective amounts of $103,294 and $35,945 and T.F.A.C., Inc. for 1974 in the amount of $122,183.

Following the filing of Taxpayers' protests for 1967, 1970, 1973, 1974, 1975, 1976, 1977 and 1978, numerous conferences with the IRS Appeals Division were held. On August 10, 1983 Taxpayers' counsel, at the request of the IRS, filed with the IRS a supplemental letter setting forth Taxpayers' position on a statute of limitations question raised by the IRS in 1983 including Taxpayers' reliance on 26 U.S.C. Section 6511(d)(1).

Finally, in 1987, the IRS negotiated a settlement with respect to the issues raised in Taxpayers' protests for 1973, 1974, 1975, 1976,

1977 and 1978. The settlement on Form 906, Closing Agreement on Final Determination Covering Specific Items ("Closing Agreement"), included a provision that the Taxpayers' NOL for 1973 would be $3,807,182. There would have been no 1973 NOL but for bad debt deductions claimed by Taxpayers for 1973 and eventually allowed by the IRS for 1973. The Closing Agreement changes included a decrease in the bad debt deduction of The Indiana National Bank of $135,464 for 1973 and increases in its bad debt deduction for 1974, 1975 and 1976 in the respective amounts of $10,216, $5,406,972 and $4,711,196; a decrease in the bad debt deduction of Indiana Mortgage Corporation of $120,058 for 1976; a decrease in the bad debt deduction of Indiana Acceptance, Inc. for 1975 and 1976 in

the respective amounts of $34,243 and $23,992; and a decrease in the bad debt deduction of INB Mortgage Holding, Inc. for 1976 of $64,387.

B. How the Statute of Limitations Section 6511(d)(1) Question Was First Raised by the IRS in 1983.

Prior to the above July 18, 1979 30-day letter to the Taxpayers from the IRS proposing overpayments for 1967, 1970 and 1973 in the respective amounts of $671,761, $802,344 and $20,918, the Taxpayers' representative met with Revenue Agents and a Group Supervisor and was advised the IRS District Counsel had agreed with the representative's letter on Section 6511(d)(1) dated April 11, 1979 that the 1970 claim for refund filed September 15, 1977 was not barred by the statute of limitations. The IRS at this point in time did not think Section 6511(d)(1) was ambiguous.

In 1983 the IRS Appeals Division Conferee in a settlement conference indicated he had an earlier communication from the IRS District Counsel concluding that the statute of limitations did not bar the 1970 claim for refund which Taxpayers filed September 15, 1977 based on bad debt deductions for 1973 and 1973 net operating loss carrybacks to the calendar 1970. He asked the Taxpayers' representative to review his files with regard to the Taxpayers' position on this statute of limitations question originally considered by the examining revenue agents and group supervisor, by the Taxpayers and ultimately by the IRS District Counsel and comment on the new case of C.E. and C.W. Armstrong v. United States, (Ct. Cl. 1982) 681 F.2d 774 which discussed Section 6511(d)(1)

of the Internal Revenue Code seven year bad debt statute of limitations but which did not cite the previous leading case from the same Court of Appeals, Smith Electric Company, Inc. v. United States, (Ct. Cl. 1972) 461 F.2d 790, which also dealt with the special seven year bad debt statute of limitations. Accordingly, by letter dated August 10, 1983, such comments were sent to the IRS Conferee, this letter was attached to the Taxpayers' refund complaint as Exhibit D and appears in the Appendix IV, pages A-93 to A-130. Prior to 1983 and the 1982 Court of Claims Armstrong decision the Taxpayers and the examining IRS revenue agents, IRS group supervisor and IRS District Counsel in reading the words in Section 6511(d)(1) did not think Section 6511(d)(1) was ambiguous and had all concluded the Taxpayers' 1970 and 1967 income tax

claims for refund were timely filed under the Section 6511(d)(1) special seven-year period of limitation applicable to net operating loss carrybacks which involve bad debt deductions.

C. **Basis for Federal Jurisdiction in Court of First Instance.**

The Taxpayers filed suit in the United States District Court for the Southern District of Indiana, Indianapolis, Indiana ("District Court") for the recovery of federal internal revenue corporate income taxes pursuant to 28 U.S.C. 1346(a)(1). Proper venue lay in the District Court's judicial district which included Indianapolis, Indiana where the Taxpayers principal places of business were located.

REASONS FOR GRANTING THE WRIT

I. **The decision below that the Government by a Revenue Ruling may**

insert the following quoted additional phrase in Section 6511(d)(1) requiring that the bad debt deduction be "newly discovered or increased" for the special seven year bad debt period of limitation to apply, raises an important question which should be settled by this Court as to whether the Government must stick to the plain meaning of the statute relied upon by taxpayers.

This Court has not previously addressed this question of the plain meaning of a statute of limitations, except possibly this Court's recent January 25, 1993 opinion in Bufferd v. Commissioner, _____ U.S. _____, 71 AFTR 2d 93-573 (1993) which referred to the "plain language of §6501(a)". The below Seventh Circuit decision recognized that the question of which Internal Revenue Code provision applied "is a close one", but then changed the plain meaning of the statute.

A. There is no language in Section 6511(d) that affords the Government a right to insert the following quoted additional phrase in Section 6511(d)(1)

requiring that the bad debt deduction be "newly discovered or increased" for the special seven year bad debt period of limitations to apply.

In 1973, the relevant provisions of Section 6511(d)(1) read as follows:

> "(1) Seven year period of limitation with respect to bad debts and worthless securities -- If the claim for credit refund relates to overpayment of tax imposed by subtitle A on account of --
>
> (A) The deductibility by the taxpayer, under § 166 or § 832(c), of a debt as a debt which became worthless, or
>
> (B) the effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover, in lieu of the three-year period of limitation . . .; the period shall be seven years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be . . . seven years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires

> the later. In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph." 26 U.S.C. §6511(d)(1973). (Underlining supplied).

As clearly stated by paragraph (1) and the above underlined language following subparagraphs (A) and (B), the statute applies to carrybacks, if (i) a claim for credit or refund (ii) relates to an overpayment (iii) on account of the effect the deductibility of a bad debt has (iv) on the application to the taxpayer of a carryback, (v) the period of limitation for filing a refund claim with respect to the carryback is extended to the later of two alternative dates. The Taxpayers' claims for refund for 1967

and 1970 are both based on such carrybacks.

The first alternative date is seven years from the Code's deadline for filing the tax return for the year of the net operating loss which generates the carryback (rather than the year to which the carryback is taken). In this case, it is undisputed that seven years from the earliest filing date under the Code for plaintiffs' 1973 return is March 15, 1981. Thus, since the claims for refund Forms 1120X for 1970 and 1967 were filed on September 15, 1977, the Taxpayers' claims for refund based on the carrybacks were filed three and one-half years before the seven year deadline provided in subsection (d)(1) if Section 6511(d)(1) applies in this

case.[1/]

A reading of Section 6511(d)(1) reveals that if the following requirements are met, the seven year period of limitations applies in this case: (i) a claim for credit or refund (i.e., the Taxpayers' 1967 and 1970 claims for refund), (ii) relates to an overpayment (i.e., the Taxpayers' overpayments in 1967 and 1970) (iii) due to the effect of the deductibility of a bad debt (i.e. the effect of the Taxpayers' bad debt deduction for 1973 was to generate the NOL), (iv) has on the application to a taxpayer of a carryback (i.e., the effect of the

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1/ The second alternative is the period prescribed in paragraph (2) of subsection (d). Because a taxpayer must utilize the later to occur of the two alternatives, in this case, the Taxpayers would utilize the first alternative. This Petition therefore addresses the special limitation period on the basis the seven year period deadline applies.

Taxpayers' 1973 NOL attributable to the bad debt deduction is that the NOL may be carried back), then the period of limitations is the longer seven year period.

Throughout the Government's briefs the attempt was made to engraft new additional different words and significant additional requirements onto the provisions of Section 6511(d)(1) and therefore give subsection (d) a wholly different meaning by requiring that the bad debt deduction be newly discovered or later increased. Indeed, the special meaning the Government attempted to impose on Section 6511(d)(1) constituted its entire position with respect to this issue first raised in 1983.

The statute simply was not drafted to support Government's interpretation. The indisputable fact is that absent

the Taxpayers' bad debt deductions for 1973, there would have been no NOL to carry back to 1970 and no ITC to carry back to 1967. It is also unquestionable that the NOL and ITC were available to Taxpayers for carryback.

The effect of the 1973 bad debt deduction, as finally determined,[2/] was to generate NOL and an ITC available for carryback, which carrybacks resulted in claims for refund for the Taxpayer, which like most banks and other lending instituions necessarily

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2/ In its arguments, the Government emphasized the fact that the Taxpayers' 1973 bad debt deduction was adjusted downward several times. Section 6511(d)(1) does not exclude reduced bad debt deductions from its scope. Indeed, as discussed by Taxpayers, the various adjustments to Taxpayers' 1973 bad debt deduction drive home the point that this type of deduction, by its very nature, is subject to adjustment in later years and thus qualifies for a longer period of limitation for filing refund claims--whether or not it actually undergoes adjustment.

over the years will have numerous bad debts. Banks especially by reason of their extensive lending must be given a greater latitude with regard to bad debt adjustments. The above facts are all that Section 6511(d)(1) require for the application of the seven year period of limitations.

B. Section 6511(d)(1) applies because the effect of the Taxpayers' 1973 bad debt deduction was to generate the NOL.

The Government argued that Section 6511(d)(1) only applies in cases where a taxpayer has either (i) taken no bad debt deduction for a taxable year and in a later year discovers a bad debt deduction should have been taken in the earlier year or (ii) taken a bad debt deduction for a taxable year and in a later year discovers that the deduction should be increased. The District Court Opinion agreed with the

Government that Section "6511(d)(1) only applies where the bad debt deduction is newly discovered or increased" and the Seventh Circuit adopted the District Courts interpretation of Section 6511(d)(1).

The lynchpin of the Government's proposed construction of Section 6511(d)(1) was its interpretation of the words "on account of the effect" of a bad debt deduction "on the application to the taxpayer of a carryback." The Government argued that in order for a bad debt deduction to have an effect on the application to a taxpayer of a carryback, the effect can only be caused by a later-discovered or increased bad debt deduction after the return for the year giving rise to the NOL is filed. In the Government's view, it is insufficient that a bad debt deduction either contributes to an

NOL or even generates the entire NOL. The Taxpayers' believe this interpretation is incorrect and contrary to the unambiguous language of the statute, which even the local District Director and District Counsel concluded up until 1983 was not ambiguous and permitted the Taxpayers claimed refunds to be made, but in an amount different than finally agreed upon.

The statute Section 6511(d)(1) clearly states that if a bad debt deduction effects an NOL carryback, then the special seven year period of limitations applies. In this case, the Taxpayers' bad debt deduction for 1973, whether as originally reported, as revised, or as finally determined over 12 years later in the 1987 Closing Agreement certainly had an effect on the Taxpayers' 1973 NOL. Simply put,

without the 1973 bad debt deduction, there would have been absolutely no NOL or ITC carryback by the Taxpayers.

In judging whether one item has an effect on a second item, normally the second item is viewed separately and then in combination with the first item. Thus, if the Taxpayers' NOL is viewed separately without the benefit of the bad debt deduction, the NOL disappears. Surely this effect is sufficient to satisfy the statute. Webster's Seventh New College Dictionary (rev. ed. 1972) defines the noun "effect" as follows: "1: something produced by an agent or cause: . . . "

If the 1973 NOL is judged under this definition, the result of the bad debt deduction is clearly the generation of the NOL. Despite the fact there would have been no 1973 NOL

for the Taxpayers had there been no bad debt deduction, the Government argued that the deduction's "effect" on the NOL "has to mean something more." What greater effect on the NOL could the bad debt deduction have? Whether it was as originally reported, newly discovered, increased or reduced is irrelevant; the fact of the matter is that under any interpretation the 1973 NOL occurred as a direct result of the bad debt deduction for that year.

The Government argued that the effect of the bad debt deduction in this case must be "something more" than an NOL which would not exist but for the bad debt deduction. The Government's argument is explicitly rejected by the statute itself since it requires merely that the result of the bad debt deduction have an effect on

the NOL. In this case, if the Taxpayers' bad debt deduction were removed, no NOL would exist. This is sufficient to satisfy the plain meaning of the statute. As discussed below, in subsection I.C. of this Petition the Regulations promulgated under Section 6511(d)(1) confirm this interpretation.

The plain meaning of Section 6511(d)(1) does not emasculate paragraphs (2) and (4) of subsection (d) as the Government argued. The statute allows taxpayers with bad debt deductions which have an effect on their NOL a longer period of time to file refund claims because bad debt deductions, by their very nature, are subject to change and have been the subject of much dispute and litigation, as the facts leading up to this case demonstrate. It took over 12 years for

the Taxpayers' 1973 bad debt deduction and NOL to be finally determined in the 1987 Closing Agreement. Congress did not take the significant additional step of requiring the bad debt deduction to be later discovered or increased as the Government would require.

The Taxpayers submit there is a substantial difference between the effect on a court of Treasury Regulations prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury and Revenue Rulings that are no more than the opinion of any other lawyer.

C. Sections 6511(d)(2)(a) and (d)(4)(a) relied upon by the Government contain general rules for filing claims for refund involving carrybacks, NOLs and ITCs and nowhere in these statutory paragraphs quoted in the Seventh Circuit Opinion do the words "bad debts" appear nor did Taxpayers rely on those sections.

Section 6511(d)(2)(A), which the Government argues and the Seventh Circuit Opinion concluded is applicable to the Taxpayers' refund claims, contains a special period of limitations with respect to NOL or capital loss carrybacks. Section 6511(d)(4)(A) relates to the period of limitations with respect to ITC carrybacks.

The relevant provisions of Section 6511(d)(2)(A) referred to in the Seventh Circuit Court Opinion read as follows:

"(2) Special period of limitations with respect to net operating loss or capital loss carrybacks. -

> (A) period of limitations. - If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback or a capital loss carryback, in lieu of the 3-year period of limitations prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th

> day of the 40th month (or the 39th month, in the case of a corporation) following the end of the taxable year of the net operating loss . . . which results in such carryback ..." 26 U.S.C. §6511(d)(2)(A) (1973) (as amended by the Tax Reform Act of 1969, Pub. L. No. 91-172. 83 Stat. 487, 696, §512(e)(2)(1969)).

Under Section 6511(d)(2)(A), were it applicable, the Taxpayers' claims for refund for 1970 and 1967 would have been required to be filed on March 15, 1977 rather than September 15, 1977, which was the date the claims were actually filed. Section 6511(d)(4)(A) contained an essentially identical period of limitations with respect to ITC carrybacks. Nowhere in these statutory provisions do the words "bad debt" or the Section under which bad debts are deductible appear. Therefore, the Taxpayers did not and do not rely on those Sections 6511(d)(2) and (d)(4)(A).

D. Methods of calculation and deduction of bad debts have resulted in a history of considerable litigation, both increases and decreases of bad debt deductions of financial institutions, including large bad debt adjustments both increases and decreases for the Taxpayers in the 1970's.

In discussing the provisions of Section 6511(d)(1) it is important to note that Sections 165(g) and 166 cited in Section 6511(d)(1) relate to the deduction for worthless securities and bad debts, respectively. The bad debts deducted by the Taxpayers in 1973 were deducted under Section 166.

Not surprisingly, the determination of whether a debt has become wholly or partially worthless has been the subject of considerable litigation between taxpayers (especially banks, credit, loan and financial institutions such as the

Taxpayers) and the IRS, especially with respect to whether the charge-off of a particular debt was made in the appropriate year. See, e.g., Atlantic Bank & Trust Co. v. Commissioner, 10 BTA 796 (1928); Winder National Bank v. Commissioner, 16 BTA 12 (1929); Southeastern Finance Company v. Commissioner, 4 T.C. 1069 (1945), aff'd. 153 F.2d 205 (5th Cir. 1946); S.W. Coe & Co. v. Dallman, 216 F.2d 566 (7th Cir. 1954); The First National Bank of La Feria v. Commissioner, 24 T.C. 429 (1955), aff'd. 234 F.2d 868 (5th Cir. 1956); Nichols Loan Corporation of Terre Haute v. Commissioner, T.C. Memo 1962-149, rev'd on other grounds, 321 F.2d 905 (7th Cir. 1963) (7th Circuit did not consider the bad debt deduction issue);

and Industrial Credit Co., Inc. v. Commissioner, T.C. Memo 1967-75.

In 1973, under Section 166(c), taxpayers could elect to utilize the "reserve method" for deducting bad debts.

As is the case with taxpayers who utilize the direct charge-off method, the reserve method was the source of a tremendous amount of litigation, especially the issue of whether a taxpayer's additions for a particular year were reasonable. See, e.g., Calavo, Inc. v. C.I.R., 304 F.2d 650 (9th Cir. 1962), rev'g. and rem'g. T.C. Memo 1960-242; and High Plains Agricultural Credit Corp., v. C.I.R., 63 T.C. 118 (1974).

The District Court Opinion and Seventh Circuit Opinion failed to recognize or appreciate the substantial

adjustments (increases and decreases) to the Taxpayers' bad debt deductions as evidenced by:

(a) the Form 1120X for 1973 filed on December 31, 1974 reflecting a $162,218 reduction in the Taxpayers' aggregate bad debt deduction to agree with a 1972 Revenue Agent's Report for that year which was then in progress;

(b) the 30-day letter issued by the IRS with respect to the Taxpayers, which included a $135,464 reduction in the bad debt deduction of The Indiana National Bank for 1973 and an increase in its bad debt deduction of $10,216 for 1974; reductions of $103,294 and $35,945 in the bad debt deduction of Indiana Mortgage Corporation for 1973 and 1974, respectively; and a $123,183 reduction in the bad debt deduction of TFAC for 1974; and

(c) the Form 906, Closing Agreement on Final Determination Covering Specific Matters, executed by the parties in 1987, which included a reduction to the bad debt deduction of The Indiana National Bank of $135,464 for 1973 and increases in its bad debt deduction for 1974, 1975 and 1976 in the respective amounts of $10,216, $5,406,972 and $4,711,196; a reduction in the bad debt deduction of Indiana Mortgage Corporation of $120,058 for 1976; reductions in the bad debt deduction of Indiana Acceptance, Inc. for 1975 and 1976 in the respective amounts of $34,243 and $23,922; and a

reduction in the bad debt deduction of INB Mortgage Holding, Inc. for 1976 of $64,387.

These adjustments to Taxpayers bad debt deduction clearly show the extent to which bad debt deductions are subject to change both as to timing and amount, both increases and decreases.

E. Section 6511(d)(2)(a)(ii) shows Congress did not intend to require bad debt deductions to be newly discovered or increased for Section 6511(d)(1) to apply and Congress is capable of enacting restrictive language to a statute of limitations involving NOL carrybacks where Congress intends such restrictions.

The very position relied upon by Government in its Motion shows that, had Congress intended to include in Section 6511(d)(1) the requirement that the bad debt deduction be newly discovered or increased, it would have done so in plain language. Section 6511(d)(2)(A), which, according to Government applies in this case,

contains the shorter period of limitations applicable to claims for refund attributable to NOLs. Clause (ii) of Section 6511(d)(2)(A), as it read in 1973, provided as follows:

"(ii) with respect to an overpayment attributable to the creation of, or an increase in, a net operating loss carryback as a result of the elimination of excessive profits by a renegotiation (as defined in section 1481(a)(1)(A)), the period shall not expire before September 1, 1959, or the expiration of the twelfth month following the month in which the agreement or order for the elimination of such excessive profits becomes final, whichever is the later." 26 U.S.C. §6511(d)(2)(A)(ii) (1973), (as added to the Code by Pub. L. No. 86-280, §1(a), 73 stat. 563 (1959) and amended by the Trade Expansion Act of 1962, Pub. L. No. 87-794, §317(b), 76 Stat. 872, 1042 (1962). (Underlining supplied).

Section 6511(d)(1)(A)(ii), created a special, longer period of limitations for filing claims for refund where the elimination of excessive profits by renegotiation created an NOL or increased an already existing NOL. In

drafting the special limitation period of Section 6511(d)(2)(A)(ii), Congress insured its provisions would be limited to overpayments of tax attributable to newly created or increased NOLs by explicitly including those words setting forth those requirements in the statute.

The Report of the Senate Finance Committee accompanying the 1959 Act which added Section 6511(d)(2)(A)(ii) to the Code vividly demonstrates that if Congress is concerned that a special limitation period under Section 6511(d)(1) be limited to newly discovered or later increased items, it will insure that specific provisions are included in the legislation:

"The amendments apply only to that portion of the overpayment for any taxable year which is attributable to the creation of, or an increase in, a net operating loss carryback as a result of the elimination of excessive

profits by renegotiation. There will be no extension, by reason of this bill, for any portion of the overpayment which is not so attributable." S.R. No. 663, 86th Cong.. 1st Sess. 622, 623, U.S. Code Cong. & Admin. News 2591, 2592 (1959). (Emphasis supplied).

If Congress had the same concern when it drafted Section 6511(d)(1) as it had when it drafted Section 6511(d)(2)(A)(ii), it would have included similar or identical restrictive language in Section 6511(d)(1). Yet Section 6511(d)(1), the provisions of which are characterized by Government as "careful wording", simply does not require the bad debt deduction to be newly discovered or increased. The District Court Opinion dismissed the logic of this argument of the Taxpayers stating that "If both of these sections were drafted concurrently and related to the same subject, the plaintiffs' argument

might have some force." However it has been held a court may, in interpreting specific language in a statute, consider subsequent Congressional action and later law is entitled to weight when it comes to a problem of construction. Federal Housing Administration v. The Darlington, Inc., 358 U.S. 84, 3 L.Ed 2d.132 (1958). Accord: A. P. Green Export Company v. United States, 284 F.2d 383 (Ct. Cl. 1960).

In the Green case involving Section 109 of the Internal Revenue Code of 1939 the Government cited a single example from the report of the Senate Committee on Finance dealing with a corporation engaged in mining activities in South America. The Court held the effect of the statute should not be severely restricted to the

illustration used in the Committee Report, since it in no way appears that the example was used for that purpose. Further, the Court looked to the later Congress reenactment of the Western Hemisphere trade corporation provisions in Section 921 of the Internal Revenue Code of 1954 indicating that, while subsequent legislation may not be controlling, it may not be disregarded.

The point the Taxpayers are making is that Congress has proven itself quite capable of enacting restrictive language to a statute of limitation involving NOL carrybacks by the use of such words as "creation of" or "an increase in" as shown in the 1959 Act which added Section 6511(d)(2)(A)(ii). Likewise, the single example in a portion of a House Report on Section 332(b)(5) of the Internal Revenue Code

of 1939 to which the District Court Opinion refers where "later evidence" revealed to a taxpayer a debt had previously become worthless, should not be used to severely restrict Section 6511(d)(1), since in no way does it appear that the example was used to insert such words as "creation of" or "an increase in" into the seven year bad debt statute.

F. The basic rules of statutory construction require rejection of the Government's and the lower Court's interpretation of Section 6511(d)(1), since the absence of the specific requirement that the bad debt deductions be newly discovered or increased is evidence this requirement was not intended and courts are not authorized to rewrite a statute and graft upon the statute something not already there.

If Congress had intended Section 6511(d)(1) to require the bad debt deduction be "newly discovered" or "increased", it would have included these requirements in paragraph (1) as

it did when drafting Section 6511(d)(2)(A)(ii). To attempt to engraft such significant requirements simply distorts the statute's unambiguous meaning and is contrary to the well-established principles of statutory construction discussed below. The absence of specific provision is evidence that it is not intended. Central Real Estate Co. v. Commissioner, 47 F.2d 1036 (5th Cir. 1931); Shield Co., Inc. v. Commissioner, 2 T.C. 763 (1943); Wegman's Properties, Inc. v. Commissioner, 78 T.C. 786 (1982). This Court in Bodaracco v. Commissioner, 464 U.S. 386, 398, 78 L.Ed.2d 549 (1984), stated "Courts are not authorized to rewrite a statute because they might deem its effect susceptible of improvements."

It has been held the courts cannot graft upon the statute something not already there. Helvering v. Rebsamen Motors, Inc., 128 F.2d 584 (8th Cir. 1942). According to Panhandle Refining Co. v. Commissioner, 45 BTA 651 (1941), it is the prerogative of a Court to construe the statute, not to add to it. In Smietanka v. First Trust & Savings Bank, 257 U.S. 602, 606, 66 L.Ed. 391 (1922), Justice Brandeis said:

> "But nowhere (in the Act) was words used which can be stretched to include unborn beneficiaries for whom income may be accumulating. It may be that Congress had a general intention to tax all incomes whether for the benefit of persons living or unborn, but a general intention of this kind must be carried into language which can be reasonably construed to effect it. * * * The provisions of such acts are not to be extended by implication.

The basic rule of statutory construction is that the beginning point in any case involving statutory interpretation is the language of the

statute itself and that if the language is plain and unambiguous on its face, it should be given effect. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-202, 47 L.Ed. 2d 668 (1976); Peare v. McFarland, 778 F.2d 354, 357 (7th Cir. 1985). The most important tool in construing the meaning of a statute levying taxes is the literal meaning of the words employed in the statute, and not the insertion of words such as "newly discovered" or "increased," as the Government suggested in its Briefs and the District Court adopted in its Opinion. United States v. Merriam, 263 U.S. 179, 187-188, 68 L.Ed. 240 (1923). The reference in the District Court's Opinion to the Government's citation of Lehman v. Nakshian, 453 U.S. 156, 69 L.Ed. 2d 548 (1981), for the principle that limitations upon the

United States consent to be sued must be strictly observed is misplaced. The Taxpayers' submit this principle does not authorize the Government or Lower Courts in effect to add new language to the statute.

G. Section 6511(d)(1) and the Treasury Regulations under Section 6511(d)(1) explicitly refute the conclusion of "redundancy" contained in the District Court's opinion by providing a sorting mechanism which limits the utilization of the NOL carryback under Section 6511(d)(1) to that portion of the carryback which pertains to the deductions for bad debts and worthless securities.

In advancing its arguments, the Government fails to cite or even to refer to the Treasury Regulations promulgated under Section 6511(d)(1). It is axiomatic that when interpreting a provision of the Code, the Regulations (not Revenue Rulings such as Revenue Ruling 55-523, 1955 C.B. 497) must be accorded substantial weight. Lykes v. United States, 343

U.S. 118, 127, 96 L.Ed. 791 (1952); Korth v. Mountain City Copper Co., 174 F.2d 295, 297 (10th Cir. 1949). The Regulations provide no basis for the Government's interpretation of Section 6511(d)(1); indeed, they make no reference to a requirement that a taxpayer's bad debt deduction be newly discovered or increased.

What the Regulations do provide, however, is a sorting mechanism which limits the utilization of the NOL carryback under Section 6511(d)(1) to that portion of the carryback which pertains to the deductions for bad debts and worthless securities. In so doing, the Regulations implement the last sentence of Section 6511(d)(1). With respect to the seven year period of limitation applicable to NOL carrybacks under Section 6511(d)(1), the Regulations Section

301.6511(d)-1(a) provide in relevant part as follows:

"(2) If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of a debt or loss, described in subparagraph (1) of this paragraph [i.e., the deduction for bad debts and worthless securities under Sections 166 and 165(g), respectively], has on the application to the taxpayer of a net operating loss carryback provided in Section 172(b), the period in which claim for credit or refund may be filed shall be whichever of the following two periods expires later;

(i) Seven years from the last date prescribed for filing a return (determined without regard to any extension of time for filing the return) for the taxable year of the net operating loss which results in such carryback, or

(ii) The period which ends with the expiration of the period prescribed in section 6511(c) within which a claim for credit or refund may be filed with respect to the taxable year of the net operating loss which resulted in the carryback." Treas. Reg. §301.6511(d)-1, supra. T.D. 6172, 5-2-56 as amended by T.D. 6425, 11-11-59.

The Regulations make no reference whatsoever to newly discovered or increased bad debt deductions which

surface after the loss year. The sole prerequisite is that the taxpayer have an NOL which is effected by the bad debt deduction for the year and that the NOL may be carried back. Thus, if the taxpayer has a bad debt deduction and an NOL which will result in a carryback as the Taxpayers have in this case, the taxpayer has, at a minimum, seven years from the due date of its return for the taxable year of the NOL resulting in the carryback to file claims for credit or refund which arise due to the carryback.

The Government argues the "unfairness" of an extended period of limitations for refund claims based on an NOL generated in a year in which the taxpayer has both bad debt deductions and other items of deduction. The Government claims it was inappropriate to allow items which would otherwise be

barred from supporting a claim for refund under the provisions of Section 6511(d)(1) to be pulled along by a bad debt deduction and used to offset an overpayment in a prior year. Neither the Code nor the Regulations allow this to occur.

The last sentence of Section 6511(d)(1), as amplified by Section 301.6511(d)-1(a)(3) and (4) of the Regulations, establishes a sorting mechanism pursuant to which taxpayers who have deduction items for a taxable year (but which are barred from being carried back due to the expiration of the period of limitations otherwise applicable to those items) in which they also have bad debt deductions will only be entitled to utilize the seven year period of limitations with respect to the portion of the NOL attributable to the bad debt deduction. The last

sentence of Section 6511(d)(1) provides as follows:

"In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph. 26 U.S.C. §6511(d)(1)(1973). (Emphasis supplied)

Section 6511(b)(2) otherwise limits the amount of the credit or refund to the amount of tax paid within the general period of limitations provided in Section 6511(a), while Section 6511(c) extends such general period of limitations to six months after the expiration of an agreement between a taxpayer and the IRS to extend the period of time for assessing a tax imposed by Title 26, U.S.C. Section 6511(d)(1) allows a claim for refund filed under its provisions to exceed the tax paid within the periods prescribed in subsection (b)(2) or (c),

whichever is applicable, but only to the extent the refund is attributable to the bad debt or worthless security deduction.

Section 301.6511(d)-1(a)(3) and (4) of the Regulations implements the last sentence of Section 6511(d)(1) and addresses both (i) NOL carrybacks which are attributable to bad debt (and worthless security) deductions and other deduction items which are not barred from carryback and (ii) NOL carrybacks attributable to NOL carrybacks which are attributable to bad debt (and worthless security) deductions and other deduction items which are barred from carryback.

In the case of NOL carrybacks which are based in part on deductions other than bad debts (and worthless securities) which are otherwise barred from carryback by the period of

limitations applicable to those items, the Regulations provide:

"(4) If the claim involves an overpayment based not only on the deductibility of items described in subparagraph (1) of this paragraph [i.e., bad debts and worthless securities] but based also on other items, and if the claim with respect to any items is barred by the expiration of any applicable period of limitations, the portion of the overpayment attributable to the items not so barred shall be determined by treating the allowance of such items as the first adjustment to be made in computing such overpayment." Treas. Reg. §301.6511(d)-1(a)(4), supra. as amended by T.D. 6425, 11-11-59 (Emphasis supplied).

The final two phrases of subparagraph (4) of Section 301.6511(d)-1(a) of the Regulations provide that the portion of the overpayment attributable to the bad debt and worthless security deductions is determined by treating the allowance of the bad debt and worthless security deductions as the first adjustment to

be made in computing the overpayment in the year to which the NOL is carried.

Thus the Taxpayers' carryback of their NOL from 1973 to 1970 must be determined by first stripping away any deductions for 1973 which would be barred from carryback by the period of limitations applicable to NOLs (i.e., all deductions except those relating to bad debts and worthless securities and any other items under Section 6511(d) which enjoy a period of limitations which expired on or after September 15, 1977) and treating the bad debt deduction as the first item to offset the overpayment.

Congress, in drafting Section 6511(d)(1), and the Department of Treasury, in implementing Section 6511(d)(1) through promulgation of the

Regulations, had those situations in mind in which taxpayers with bad debt deductions generating NOLs would have other constituent elements in the NOLs not subject to the special seven year period of limitations. Therefore, to provide an ordering or sorting procedure pursuant to which the bad debt (or worthless security) deduction would be extracted from the NOL, both Congress and the Department of Treasury specified the bad debt (and worthless security) deduction would be determined by treating the allowance of those items as the first adjustment to be made in computing the overpayment for the year to which the NOL is carried.

This ordering and sorting procedure implicit in Section 6511(d)(1) is the reason contrary to the statement of "redundancy" of the District Court's Opinion that this

Court on appeal should find Section 6511(d)(1) is not ambiguous and Section 6511(d)(1) and Section 6511(d)(2)(A) are not redundant as suggested by the following erroneous language in the District Court Opinion:

> Paragraph (d)(2)(A) of Section 6511 provides an extended limitations period for a credit or refund claim which "relates to an overpayment attributable to something more than a net operating loss carry back . . . ." This suggests that to avoid redundancy, paragraph (d)(1) must relate to situations in which the claim is attributable to something more than a net operating loss carryback, thereby supporting the defendant's emphasis, although not ruling out the plaintiffs' interpretation. (Underlining supplied)

Sections 6511(d)(1) and 6511(d)(2)(A) are not ambiguous and are not redundant but cover different situations. Neither is superfluous or a repetition. In the context of Section 6511(d)(1), the Taxpayers' NOL is attributable to the bad debt

deduction. Under the last sentence of Section 6511(d)(1) and Section 301.6511(d)-1(a)(4) of the Regulations, the entire bad debt deduction must be carried back to 1970 to the extent of the amount of the overpayment and resulting refund for that year. This situation of sorting does not occur where there is a NOL and no bad debt deductions involved and the NOL is carried back under Section 6511(d)(2)(A) not under Section 6511(d)(1).

H. The legislative history reveals that Congress did not require bad debts to be newly discovered or increased for Section 6511(d)(1) to apply and the portion of the House report cited by the District Court opinion does not refer to a bad debt later increased or later decreased.

The Government's reliance on a small excerpt from the legislative history is misplaced. Where a statute is plain and unambiguous on its face,

courts will not ordinarily look to legislative history as a guide to its meaning, Ex Parte Collett, 337 U.S. 55, 61, 93 L.Ed. 1207 (1949); Director, Office of Workers' Compensation Programs, U.S. Department of Labor v. Forsyth Energy, Inc., 666 F.2d 1104, 1107 (7th Cir. 1981).

The District Court Opinion noted that the Government in support of its construction of Section 6511(d)(1) cited a portion of a House Report on Section 322(b)(5) of the Internal Revenue Code of 1939, added by the Revenue Act of 1942, ch. 619, 56 Stat. 798 (Appendix VII) which was the forerunner of Section 6511(d)(1) and which provided a seven year limitation period for claims on bad debts. Specifically, the House Report No. 2333 (Appendix VII) in speaking of the seven year bad debt statute of limitations is

entitled "Longer Statute of Limitations For Bad Debts and Worthless Stock Losses."

The District Court Opinion recognized and the Taxpayers several times pointed out that the excerpt does not refer to a situation where a bad debt is later increased or later decreased. See A.P. Green Export Company supra and discussion at page 38 of this Petition that a single example in a Congressional Report is not considered an overall restriction.

II. The decision below is in conflict with the Court of Claims case of Smith Electric Co., Inc. v. United States 461 F.2d (Ct. Cl. 1972) which rejected the same argument by the Government as in this case.

The District Court Opinion indicated there was little case law on the Section 6511(d)(1) issue and mentioned the only such case law being

the two Claims Court cases of Smith Electric Co., Inc., supra, cited by the Taxpayers and Armstrong v. United States, supra, cited by the Government as not controlling. Notwithstanding the District Court Opinion's statement that Smith Electric did not assist the District Court's analysis, the Taxpayers submit that the Taxpayers' position is fully supported by the Court of Claims decision in Smith Electric. The Government's brief in the Smith Electric case was attached as Exhibit K to the Taxpayers' September 28, 1988 Brief to the District Court, is set forth in full in Appendix VI, and indicated that, in support of the enactment of the predecessor of Section 6511(d)(1), the Department of Treasury did not intend the statute to contain the limitations advanced by the

Government. The testimony before Congress of Mr. Randolph Paul, the Tax Advisor to the Secretary of Treasury, with respect to the new seven year period of limitations is particularly illuminating in this regard as set forth in the Government's Brief in the Smith case as follows:

"(c) Statute of limitations on bad debts and worthless stock losses. - The difficulties surrounding the deduction for bad debts and worthless stock losses have long been familiar sources of irritation to taxpayers and the Commissioner alike. It is far from easy to ascertain when a debt is bad or when a share of stock becomes worthless. At the same time, the taxpayer must select the proper year before the statute of limitations has run with respect to that year.

Much litigation is occasioned by the artificial barrier thus thrown up by the statute of limitations, as a taxpayer who chose one year only to be met with the claim that an earlier but barred year was the correct year must battle to defend his choice or lose the deduction entirely.

It is believed that this useless litigation and many of the difficulties in this field can be avoided by, first, eliminating the ascertainment of

worthlessness and the charge-off requirements in the case of bad debts--including securities producing capital losses-and, second, allowing a 7-year statute of limitations with respect to refund claims relating to a deduction on account of these items." House hearings, Committee on Ways and means, 77th Cong., 2d Sess., pp. 92-93; Brief for the United States, Smith Electric Company, Inc. v. United States, No. 474-69, Nov. 2, 1971, pg. 15. (Emphasis supplied).

Surely, if the Treasury Department was concerned that new Section 322(b)(5) should be limited to those situations in which a bad debt deduction is newly discovered or later increased, as the Government argues, the Tax Advisor to the Secretary would have at least mentioned these requirements in his testimony. It is clear that Section 332(b)(5) was enacted in response to the difficulties both taxpayers and the Service encounter in connection with determining the proper year in which a

bad debt should be deducted and that no one was concerned with limiting the scope of the statute to the two situations advanced by the Government in the case at bar.

Despite the Government's argument that the Taxpayers cannot characterize Smith Electric ". . . as dealing with the issue raised here", even a brief analysis of the case reveals the court's decision was based on facts virtually identical to those present here and that the issue was essentially the same as the issue in this case. The taxpayer in Smith Electric properly added $81,943.79 to its bad debt reserve on its return for 1960; the addition was not later increased or challenged by the Service but remained at that amount. Approximately six years later, the taxpayer filed claims

for refund for its taxable years 1957 and 1958 which arose out of an NOL for 1960 attributable to the bad debt deduction. The Service disallowed the claims on the basis they were subject to the same three-year period of limitations contained in Section 6511(d)(2)(A) relied on by the Government in this case. Brief for the United States, Smith Electric, Id. at 11. (Appendix VI).

The Court of Claims quoted the same statute relied upon by Taxpayers in this case and the same excerpt from the House Report on the Revenue Act of 1942 quoted by the Government in its brief and concluded that the taxpayer, who also utilized the reserve method, was entitled to rely on Section 6511(d)(1). Smith Electric, at 793. Id. The Court of Claims concluded that

there was nothing in the period of limitations itself or in the legislative history to indicate the special seven year period contained in Section 6511(d)(1) must be limited to taxpayers who utilize the direct charge-off method. Id. Importantly, the court relied on and even quoted the basic rule of statutory construction that:

> "[T]he plain, obvious and rational meaning of a statute is to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." Lynch v. Allworth-Stephens Co., 267 U.S. 364, 370, 45 S.Ct. 274, 276, 69 L.Ed. 660 (1925)." Smith Electric, 461 F.2d at 793.

The Court of Claims in Smith Electric rejected the same argument first made by the Government in 1983 in this case that Taxpayers' claims are not allowable on the grounds they were

not filed within the three-year limitation period of Section 6511(d)(2)(A).

CONCLUSION

For all the foregoing reasons, the Taxpayers respectfully request that the Petition for a Writ of Certiorari be granted.

Respectfully submitted,

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REJ:2499:cp

92-1427

Supreme Court, U.S.
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NO. _____

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1992

INDIANA NATIONAL CORPORATION
AND ITS SUBSIDIARIES: INDIANA
NATIONAL BANK, et al.,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

APPENDIX TO
PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

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APPENDIX I

In the
UNITED STATES COURT OF APPEALS
For the Seventh Circuit

No. 92-1039

INDIANA NATIONAL
CORPORATION
AND ITS SUBSIDIARIES:
INDIANA NATIONAL BANK,
ET AL.,
Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States
District Court for the
Southern District of Indiana,
Indianapolis Division.
No. 88 C 277--**Sarah E. Barker**, Judge

ARGUED SEPTEMBER 10, 1992--
DECIDED NOVEMBER 30, 1992

Before FLAUM and RIPPLE, Circuit Judges, and Shadur, District Judge.*

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* The Honorable Milton Shadur, District Judge of the United States District Court for the Northern District of Illinois, sitting by designation.

Flaum, Circuit Judge. Indiana National Corporation and its subsidiaries appeal from the dismissal of their claims for refund of federal corporate income taxes for the years 1967 and 1970. The district court dismissed the claims as untimely, rejecting the appellants' arguments that a special seven year statute of limitations applied and, alternatively, that an agreement between the parties extended the limitations period. We affirm.

I.

The plaintiffs are affiliated corporations that filed consolidated Form 1120 income tax returns with the Internal Revenue Service. They filed a refund claim for 1970 based on the carryback of a net operating loss sustained by the taxpayers in 1973, and

a refund claim for 1967 reflecting an investment tax credit carryback from 1970 to 1967, freed up as a result of the net operating loss carryback from 1973 to 1970. The IRS never formally disallowed the refund claims, and the taxpayers brought a timely refund suit in the district court.

In September of 1974, the taxpayers filed their original claim for refund of corporate income taxes for 1973. The taxpayers' 1973 return claimed bad debts of $6,038,574, and a net operating loss of $4,125,569. In December of 1974, the taxpayers filed an amended return for 1973, reducing the bad debt deduction by $162,218. They also filed a Corporation Application for Tentative Refund from Carryback of the Net Operating Loss for 1970 in the amount of $976,764, and a

Corporation Application for Tentative Refund from Carryback of Unused Investment Credit for 1967 in the amount of $971,297.

On September 15, 1977, the taxpayers filed an amended corporate income tax return for 1970, carrying back the net operating loss from 1973, which generated a claim for refund of 1970 corporate income tax of $1,008,274. On the same day, the taxpayers filed an amended return for 1967, carrying back the investment credit from 1970 to 1967 (as a result of the net operating loss carryback from 1973 to 1970), which generated a claim for refund of 1967 corporate income tax of $862,466. The IRS and the appellant-taxpayers engaged in a series of conferences, concerning these and other tax years, until in 1987 the IRS and the taxpayers

negotiated a settlement, titled Closing Agreement on Final Determination Covering Specific Items, for all tax years at issue except for 1967 and 1970. In the Closing Agreement, the parties agreed that the taxpayers' deductible bad debts for 1973 equaled $5,903.111, and that their net operating loss for 1973 was $3,807,182.

In the course of other negotiations between the IRS and the appellants in 1975, the parties entered into an agreement for the assessment of the taxpayers' liability for Federal Excise tax for the period from January 1, 1972 through December 31, 1973, extending the statutory period of limitations to December 31, 1977. Under Internal Revenue Code §6511(c), any agreement to extend the period of assessment of "a tax imposed by this Title" creates an

extension for filing refund claims for six months after the end of the agreed period for assessment. 26 U.S.C. §6511(c). Title 26 of the United States Code imposes both excise taxes and corporate income taxes.

II.

It is undisputed that a timely claim for refund is a "jurisdictional prerequisite to refund suit." Martin v. United States, 833 F.2d 655, 658-59 (7th Cir. 1987) (citations omitted). Generally, a taxpayer may file a claim for refund within three years after the return was filed or two years after the tax was paid, whichever is later. 26 U.S.C. §6511(a). Several provisions create special limitation periods applicable to income taxes, and both parties agree that the general provision does not govern the taxpayers' claims.

The appellants argue that I.R.C. §6511(d)(1), which grants a seven year period of limitation to file claims for refund in certain circumstances, applies in this case.[1] It provides, in relevant part:

> Seven year period of limitation with respect to bad debts and worthless securities--If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of--
> (A) the deductibility of the taxpayer, under §166 or §832(c), of a debt as a debt which became worthless . . ., or
> (B) the effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover, in lieu of the three year period of limitation . . ., the period shall be seven years from the date prescribed by law for filing the return for the

[1] If it did, their refund claims would be timely because they were filed before March 15, 1981. The seven year period extends from the date "for filing the return for the year of the net operating loss which results in [a] carryback." §6511(d)(1). The date for filing the tax return for 1973, the year of the net operating loss, was March 15, 1974.

> year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be . . . seven years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback. . . .

26 U.S.C. §6511(d)(1).

The government argues that I.R.C. §§6511(d)(2)(A) and (4)(A), which create special limitation periods of thirty-eight and one half months, govern.[2] Those sections provide, in relevant part:

> Special period of limitation with respect to net operating loss or capital loss carrybacks--If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback . . ., in lieu of the three year

[2] If the government is correct, the time for filing refund claims expired on March 15, 1977, making the taxpayers' claims six months too late.

> period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the fifteenth day of the fortieth month (or the thirty-ninth month, in the case of a corporation) following the end of the taxable year of the net operating loss . . . which results in such carryback.

26 U.S.C. §6511(d)(2)(A).

> Special period of limitation with respect to investment credit carrybacks--[W]ith respect to any portion of an investment credit carryback from a taxable year attributable to a net operating loss carryback . . . from a subsequent taxable year, the period shall be that period which ends with the expiration of the fifteenth day of the fortieth month, or thirty-ninth month, in the case of a corporation, following the end of such subsequent taxable year. . . .

26 U.S.C. §6511(d)(2)(A).

The appellants focus on the specific mention of bad debt deductions in §6511(d)(1). They contend, parsing the language of the statue, that because (i) the claim for refund (ii) relates to an overpayment (iii) on account of

the effect that the deductibility of a bad debt has (iv) on the application to the taxpayers of a carryback, (v) the period of limitation must be seven years. According to this view, the taxpayers' claims are claims for refund based on overpayments in the years 1970 and 1967, due to the effect that the deductibility of bad debts (i.e., generating the net operating loss) had on the application to the taxpayers of a carryback (i.e., the 1973 net operating loss attributable to the bad debt deduction may be carried back). The taxpayers emphasize that, without the bad debt deduction, there would not have been a net operating loss.

The government refutes the applicability of §6511(d)(1) by pointing out that, because the

taxpayers' bad debt deductions decreased since the filing of their original return, the effect of the decreased deductions on the taxpayers' application of the carryback did not cause an overpayment for which they are entitled to a refund. Unless a taxpayer's bad debt deduction is newly discovered or increased after the original filing, according to this view, the effect of the deduction on the application of a carryback cannot account for an overpayment. For instance, in this case, in 1974 the taxpayers could have carried back their net operating loss, and then the investment tax credit, and could have applied for refunds for 1970 and 1967 related to their overpayments caused by the 1973 net operating loss and subsequent carrybacks. No new (or

increased) bad debt deductions, discovered after the filing of the original return, created the net operating loss for 1973, and permitted the carrybacks. The government argues that the special seven year limitation period applies to taxpayers who discover new or increased bad debt deductions because otherwise those taxpayers would lose the opportunity to apply the carrybacks and receive refunds for their overpayments.

The essence of the appellants' case is the applicability of the language permitting the seven year extension to their claims for refund. The district court found that the language itself could support either interpretation, and therefore was ambiguous. Indiana National Corporation v. United States, 775 F.Supp. 281, 285-86 (S.D. Ind.

1991). Looking to the legislative history for assistance, the court found that it favored the government's reading. The House Report of the session that enacted §322(b)(5), the forerunner of §6511(d)(1), explained the need for the statute in order to protect a taxpayer for whom "later evidence" disclosed a miscalculation about the year in which a debt becomes worthless. H.R. Rep. No. 2333, 77th Cong., 1st Sess., reprinted in 1942-2 C.B. 372, 408. The example used in the House Report depicts a taxpayer who takes a bad debt deduction in one year, but then discovers that the debt became worthless three years earlier. Under the three year rule, any claim for refund for the correct year would be lost. The legislative history suggests, without using the words

increase or create, that the government's interpretation follows the congressional intent behind the Code provision.

The district court's decision also finds support in the only case[3] that considered the applicability of §6511(d)(1) to taxpayers taking bad debt deductions, Armstrong v. Untied States, 681 F.2d 774 (Ct. Cl. 1982). Armstrong reasoned from the legislative history that "[t]he seven year period was designed to prevent possible prejudice to those taxpayers whose

[3] The appellants argue that Smith Electric Co. v. United States, 461 F.2d 790 (Ct. Cl. 1972), which addressed the seven year period, supports their interpretation, and that the facts in Smith Electric are more analogous to this case. As the district court explained, the Smith Electric court explicitly limited its analysis to comparing the applicability of the seven year period for taxpayers using the reserve method to those on the direct charge-off method. Id. at 791. Therefore, it never considered the issue in this case.

otherwise legitimate deduction might be placed in jeopardy by the general three year rule." Id. at 776. Because the taxpayers in Armstrong, like the taxpayers in this case, reported a net operating loss partly attributable to a bed debt deduction on their original return, the risk of miscalculation remedied by the seven year extension does not apply. The court in Armstrong held that if a "redetermination of the bad debt deduction itself . . . increase[d] or create[d] a [net operating loss]" for an earlier year, the seven year period would apply to refund claims. Id. at 778. Otherwise, the overpayments are not "on account of" the deductibility of a bad debt; they result from the taxpayers' "failure to utilize the [net operating loss] carryback provisions . . . within

the time allotted under . . . §6511(d)(2)(A)." Id.

The appellants use another provision in the Internal Revenue Code, §6511(d)(2)(A)(ii), which specifically requires that the "overpayment [be] attributable to the creation of, or an increase in, a net operating loss carryback as a result of the elimination of excessive profits by a renegotiation," to show that Congress includes restrictive language when it intends its statutes to be so interpreted. The problem with the parallel, as indicated by the district court, is the passage of seventeen years between the discussion and adoption of the two provisions, the first in 1942 and the second in 1959. The fact that Congress did not revise §6511(d)(1) in 1959, to include

similarly specific language, simply sheds no light on the question of Congressional intent in 1942.

The appellants further argue that the district court erred by giving undue deference to Revenue Ruling 55-523, which expressly limits the applicability of §6511(d)(1) to situations in which the bad debt deduction is newly discovered or increased.[4] The district court, however, only looked to the revenue ruling after analyzing the language of

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[4] Revenue Ruling 55-523 provides, in relevant part

> [W]here an additional bad debt . . . is determined for such loss year, the effect of which is to increase the net operating loss, §6511(d)(1) of the Code provides that a claim for refund may be filed . . . within seven years from the date . . . for filing the return for the year of the net operating loss which results in such carryback.

1955-2 C.B. 497.

the Code provisions, reviewing the legislative history, and evaluating the case law. It is proper to consider a relevant revenue ruling, Carle Foundation v. United States, 611 F.2d 1192 (7th Cir. 1979), cert. denied, 449 U.S. 824 (1980), although they are not definitive. In this case, the district court correctly used Revenue Ruling 55-523 as one of many reasons to apply §6511(d)(2)(A) and (4)(A) to the plaintiffs' claims.

The government argues, and the district court agreed, that the taxpayers' refund claims fall within §6511(d)(2)(A) and (4)(A). These provisions specifically apply to taxpayers filing refund claims for overpayments attributable to net operating loss carrybacks and investment credit carrybacks,

respectively. Moreover, interpreting §6511(d)(1) to apply to any refund claim related to an overpayment based on the carryback of a net operating loss involving any bad debt deductions makes §6511(d)(2)(A) redundant. The district court resolved the apparent redundancy by characterizing §6511(d)(1) as requiring "something more" than just any net operating loss carryback, the "something more" being an increased or newly discovered bad debt deduction that affects the taxpayer's application of a carryback.

The appellants try to refute the government's redundancy argument by characterizing the last sentence of §6511(d)(1) as a "sorting mechanism," which limits the refund to "the amount of the overpayment attributable to the deductibility" of the bad debts. The

seven year period applies only to that part of the net operating loss that is created by the bad debt deductions, distinguishing it from §6511(d)(2)(A). Still, there is no sound reason to grant additional time to those taxpayers with net operating losses that include bad debt deductions, unless the deductions result from recalculations which create or increase the net operating loss after the original filing. Congress obviously agrees with the appellants that determining when a debt becomes worthless is a difficult process, subject to errors by taxpayers and the Internal Revenue Service. For this reason, the special seven year limitation period protects those taxpayers who determine, after the refund limitation period for carrybacks

expires, that they should have taken bad debt deductions, or that they underestimated their bad debt deductions, in a particular year. Taxpayers like the appellants do not need this protection because they correctly determined, or overestimated, their bad debt deductions in the first place.

Although the question of which Code provisions apply is a close one, we agree with the district court's interpretation of §6511(d)(1) and its ruling that the taxpayers' claims for refund are governed by 6511(d)(2)(A) and (4)(A). Under these sections, the claims for refund for 1970 and 1967 were untimely.

III.

The appellants argue alternatively that their claims are timely under the

1975 extension agreement with the IRS. An agreement to extend the period for assessment of taxes creates a related extension for refund claims, under §6511(c). Because both excise taxes and corporate income taxes are part of Title 26, the appellants' argument goes, an agreement to extend the limitation period for assessment of excise taxes automatically extends the limitations period for refund claims of income taxes, or any other tax assessed under Title 26.

The extension of time for refund claims stems from considerations of fairness and reciprocity, as noted in the legislative history. H.R. Rep. No. 2333, 77th Cong., 1st Sess., reprinted in 1942-2 C.B. 372, 414. With that in mind, we agree with the district court that "[s]urely the [appellants']

protests would have been great . . . if the Internal Revenue Service had attempted to use the Consent in order to assess additional income tax." Indiana National Corporation v. United States, 775 F.Supp. at 290 (S.D. Ind. 1991).

The Code provision allows extensions by agreement for any tax imposed under Title 26. That does not mean, however, that parties may not limit the terms of their agreement to a specific tax. In this case, the Consent was expressly limited to the assessment of excise taxes. Therefore, the agreement does not affect the appellants' claims for refund of income taxes.

Because the appellants' claims for refund were untimely, the judgment of the district court is

AFFIRMED.

A true Copy:
Teste:

Clerk of the United States Court of
Appeals for the Seventh Circuit

REJ:2511:cp

APPENDIX II

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

INDIANA NATIONAL CORPORATION AND ITS SUBSIDIARIES: INDIANA NATIONAL BANK, INDIANA REALTY, INC. INDIANA NATIONAL NETWORK CORP., INDIANA MORTGAGE CORP., CONSUMER MARKETING SERVICES, INC., TOWER AGENCY, INC. INDIANA NATIONAL OVERSEAS CORP., TFAC, INDIANA NATIONAL LEASING, INC. AND CITADEL FINANCE, INC.	)	
Plaintiffs,	)	
vs.	)	IP88-277-C
UNITED STATES OF AMERICA,	)	
Defendant.	)	

ENTRY

This matter comes before the court on the defendant's motion for partial dismissal of this action for the recovery of federal corporate income

tax.[1/] Oral argument was heard on this motion on February 12, 1990.

In its motion, the United States asks this court to dismiss the plaintiffs' refund claims for the years 1967 and 1970 on the ground that these claims were not timely filed. "A timely, sufficient claim for refund is a jurisdictional prerequisite to a refund suit." Martin v. United States, 833 F.2d 655, 658-659 (7th Cir. 1987) (citations omitted). The parties disagree as to the applicable limitations period. The plaintiffs also argue in the alternative that an

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1/Although the defendant does not specify under which provision of Fed. R. Civ. P. 12 this motion is brought, since the defendant discusses the issues largely in jurisdictional terms, the court will consider this motion as having been brought under Fed. R. Civ. P. 12(b)(1).

agreement executed between the parties extended the time they had to file their claims.

I. Background

The plaintiffs are affiliated corporations (alternatively, "the taxpayers") which filed consolidated Form 1120 income tax returns with the Internal Revenue Service. They instituted this action to recover federal corporate income taxes, plus interest, for the calendar years 1973, 1970, and 1967. The refund claim for 1973 is not at issue here.

The refund claim for the year 1970 is based solely upon the carryback of a net operating loss ("NOL") sustained by the taxpayers in 1973. The refund claim for 1967 is premised in turn upon

an investment tax credit ("ITC") carryback to 1967 from 1970 "as a result of the net operating loss carryback from 1973 to 1970." Complaint, para. 21.

The taxpayers' 1973 return was due, after extensions, on September 15, 1974, a Sunday, and was filed on Monday, September 16, 1974. This return claimed bad debts in the amount of $6,038,574 and showed a NOL for the year of $4,125,569. Both parties agree that without the roughly six million dollars in bad debt deductions there would have been no NOL. However, the defendant points out that the same thing could be said for any number of the other deductions claimed by the taxpayers for 1973, totalling approximately $149 million.

The first time the plaintiffs filed an amended return for 1973 was on December 31, 1974. The first amended return reduced the bad debt deduction by $162,218 and contained various other adjustments, including increased deductions for amortization, depreciation, interest, and partnership losses. The increases of these other deductions offset the decrease in the bad debt deduction, and the NOL was increased by $509,979 to $4,635,548. The plaintiffs also filed on December 31, 1974, a Form 1139--Corporate Application for Tentative Refund for the 1973 year, showing a carryback of the NOL along with an unused ITC, from 1973 to 1971 and 1970. The plaintiffs also filed a Form 1139 on December 31, 1974, for the year 1970, carrying back an unused ITC (freed up by the NOL

carryback from 1973 to 1970) from 1970 to 1967. The plaintiffs did not at that time submit amended returns for 1970 and 1967.

The plaintiffs' second amended return was filed on January 7, 1975, to supersede the first amended return. With this second amended return, the plaintiffs claimed a refund of $8,780, plus interest.

The third amended return for 1973 was filed on September 15, 1977. As noted above, the refund claim for 1973 of $17,662, plus interest, is not at issue here. However, the third amended return showed a NOL of $4,098,674, which is $26,895 less than the NOL shown on the original return for 1973. The lower NOL on the third amended return was the result of the combined effect of a lesser upward adjustment to

deductions on the third amended return as compared with the prior two amended returns and an upward adjustment on the total income reported on the third amended return, but not on the prior two amended returns.

With this third and final amended return for 1973, the plaintiffs also filed amended returns, constituting refund claims, for both the years of 1967 and 1970 on September 15, 1977. The 1970 form shows the carryback of the amended 1973 NOL of $4,098,674 and claims a refund of $1,008,274, plus interest. The 1967 return shows the carryback of a ITC from 1970 to 1967 (after the NOL was freed up by the NOL carryback from 1973 to 1970) and claims a refund of $862,466, plus interest. The IRS never formally disallowed the refund claims for 1967, 1970, or 1973.

Attached as the plaintiff's complaint as exhibit E is a "Closing Agreement on Final Determination Covering Specific Items," entered into by the taxpayers and the IRS. This agreement reserves to the taxpayer the right to litigate the issue of whether its refund claims were timely and fixes the 1973 NOL at $3,807,182, which is less than the NOL of $4,098,674 claimed on the final amended 1973 return.

The taxpayers also executed a Form 872-B, "Consent Fixing Period of Limitations Upon Assessment of Miscellaneous Excise Taxes," for the years 1972 and 1973, allowing assessments of excise taxes until December 31, 1977.

II. Discussion

At issue is the timeliness of the plaintiffs' claims for refund for the years 1967 and 1970. As noted above, these claims were filed on September 15, 1977. As a general matter, the limitations period for filing a claim for refund, as provided in Section 6511(a) of the Internal Revenue Code of 1954 (26 U.S.C.),[2/] is the later of two years after payment or three years after the filing of the return for the tax year in question. The United States conceded in its Memorandum of Law in Support of Motion for Partial Dismissal ("Defendant's Brief"), page 9, "It appears that the

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[2/]Unless otherwise indicated, section references in this entry will be to the 1954 Code in effect with respect to the 1973 tax year.

claim filed on September 15, 1977, with respect to the 1973 year was timely filed under this provision." Neither party thinks that this general provision provides the applicable limitations period for the 1970 and 1967 years; however, they disagree as to which provision controls.

The United States maintains that the applicable provisions are found in Section 6511(d)(2)(A) and (4)(A), which contain special limitations periods for refund claims respecting overpayments attributable to NOL (and capital loss) carrybacks and investment carrybacks, respectively. As applicable to the

1973 loss year,[3/] Section 6511(d)(2)(A) provided:

> If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback ..., in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th day of the 40th month (or the 39th month, in the case of a corporation) following the end of the taxable year of the net operating loss ... which results in such carryback.

26 U.S.C. § 6511(d)(2)(A) (as amended by Section 512(e)(2) of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487). As for the carryback of the ITC from 1970 to 1967, which was

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[3/]The term "loss year" is used to indicate the tax year in which the NOL was generated, meaning 1973 in this case.

freed by the carryback of the NOL from 1973 to 1970, the limitations period found in Section 6511(d)(4)(A) provided:

> [W]ith respect to any portion of an investment credit carryback from a taxable year attributable to a net operating loss carryback ... from a subsequent taxable year, the period shall be that period which ends with the expiration of the 15th day of the 40th month, or 39th month, in the case of a corporation, following the end of such subsequent taxable year....

With respect to both the 1967 and 1970 refund claims, the limitations period under the above provisions expired on March 15, 1977. Thus, if the government's position that paragraphs (2)(A) and (4)(A)[4/] apply here is

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[4/]For simplicity's sake, the Court will hereinafter refer to Section 6511(d)(2)(A) to designate both that provision and Section 6511(d)(4)(A).

correct, the taxpayers' claims for these years, filed on September 15, 1977, were not timely.

The taxpayers, of course, maintain that another provision of the Code governs the applicable limitations period. Section 6511(d)(1), which provides a special limitations period for claims related to bad debts and worthless securities, as in effect in 1973, provided as follows:

> (d) Special rules applicable to income taxes.--
>
> (1) Seven-year period of limitation with respect to bad debts and worthless securities.--If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of--
>
> (A) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section 165(g), of a loss from

worthlessness of a security, or

(B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover,

in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later. In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in subsection (b)(2) or (c), whichever is

> applicable to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

Should this provision apply, the taxpayers' claims for refunds for 1967 and 1970, which were filed prior to March 15, 1981, would be timely.

The key to resolving this dispute is to determine whether the condition to the applicability to the seven-year limitations period in section 6511(d)(1), that "the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback," has been met in this case. "In interpreting a statute, this court's function '... is to give effect to the intent of Congress.' [United States v. American Trucking Ass'ns, 310

U.S. 534, 542, 60 S.Ct. 1059, 1063, 84 L.Ed. 1345 (1940).] The most persuasive evidence of this intent is the words selected by Congress." Director, Officer of Workers' Compensation Programs v. Forsyth Energy, Inc., 666 F.2d 1104, 1107 (7th Cir. 1981); see also United States v. Markgraf, 736 F.2d 1179, 1182 (7th Cir. 1984) ("We begin, as we must, with the language of the statute itself." (citations omitted)], cert. dismissed, 469 U.S. 1199, 105 S.Ct. 1154 (1985).

Tracking the language of the statute, the plaintiffs explain their position as follows:

> A reading of Section 6511(d)(1) reveals that if the following requirements are met, the seven-year period of limitation applies in this case: (i) a claim for credit or refund (i.e.,

> the plaintiffs' 1967 and 1970 claims for refund), (ii) relates to an overpayment (i.e., the plaintiffs' overpayments in 1967 and 1970), (iii) due to the effect of the deductibility of a bad debt (i.e, [sic] the effect of plaintiffs' bad debt deduction for 1973 was to generate the NOL), (iv) has on the application to a taxpayer of a carryback (i.e., the effect of plaintiffs' 1973 NOL attributable to the bad debt deduction is that the NOL may be carried back), then the period of limitation is the longer seven-year period.

Plaintiffs' Memorandum in Opposition to Defendant's Motion for Partial Dismissal ("Opposition Brief"), p. 13.

The defendant maintains that section 6511(d)(1) is only applicable where a taxpayer's bad debt deductions are either increased or discovered after the filing of the original return. (In this case, the plaintiffs' bad debt deductions for 1973 were only

adjusted downward after the filing of the original return.) According to the defendant, the mere fact that a NOL is composed in part, even in large part, of a bad debt deduction shown on an original return does not satisfy the plain language of the statute, which specifically provides that the overpayment for which refund is claimed must be "on account of the effect that the deductibility of [a bad debt] has on the application to the taxpayer of a carryback...." "This is because, where an originally reported bad debt deduction contributing to an NOL is decreased, the 'effect' of such decrease on the carryback would not generate an overpayment." Defendant's Brief, p. 14.

Both the plaintiffs' and the defendant's readings of the statute are

plausible. Although the plaintiffs' interpretation initially appears more straightforward, as it does not depend on emphasizing any particular words, the defendant's interpretation of the statute gains strength when (d)(1) is read in the context of Section 6511 as a whole. As the Supreme Court has dictated, "statutory language must always be read in its proper context. 'In ascertaining the plain meaning of [a] statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole.' K-Mart Corp. v. Cartier, Inc., 486 U.S. 281, 291 (1988)." McCarthy v. Bronson, ____ U.S. _____, 111 S.Ct. 1737, 1740 (1991). Paragraph (d)(2)(A) of section 6511 provides an extended limitations period for a credit or refund claim

which "relates to an overpayment attributable to a net operating loss carryback...." This suggests that to avoid redundancy, paragraph (d)(1) must relate to situations in which the claim is attributable to something more than a net operating loss carryback, thereby supporting the defendant's emphasis, although not ruling out the plaintiffs' interpretation. Since the language of the statute cannot plainly be construed to support one position as opposed to the other, the court finds that section 6511(d)(1) is ambiguous.

The taxpayers contend that any ambiguities in this statute should be construed in favor of the taxpayers. They cite Gould v. Gould, 245 U.S. 151, 153, 38 S.Ct. 53, 62 L.Ed. 211 (1917), in which the Court noted, "In case of doubt [statutes levying taxes] are

construed most strongly against the government, and in favor of the citizen." (citations omitted). Although part of the Internal Revenue Code, section 6511(d)(1) does not itself impose any taxes, rendering this principle of questionable applicability. Moreover, the United States counters with the principle that limitations upon the United States' consent to be sued must be strictly observed. Lehman v. Nakshian, 453 U.S. 156, 161, 101 S.Ct. 2698, 2702, 69 L.Ed.2d 548 (1981). The competing principles invoked by the parties provide little help in resolving the ambiguity of section 6511(d)(1).

When the wording of a statute is ambiguous, a court may look to its legislative history for assistance in determining the statute's meaning.

Ballard v. Commissioner, 854 F.2d 185, 188 (7th Cir. 1988). In support of its construction of section 6511(d)(1), the defendant cites the following portion of a House Report on section 322(b)(5) of the Internal Revenue Code of 1939, added by the Revenue Act of 1942, ch. 619, 56 Stat. 798, which was the forerunner of section 6511(d)(1) and which provided a seven-year limitation period for claims based on bad debts:

> Under the existing law, the taxpayer may be whipsawed out of a deduction for a bad debt because of the uncertainty as to the time at which the debt becomes worthless. Later evidence often discloses that present decisions as to the year in which a debt becomes worthless are erroneous. For example, the taxpayer concludes that a debt has become bad and takes the deduction in that year, only to discover by later evidence that the debt actually became worthless three years previously. The statute of

> limitations having run on such previous year, this deduction is lost forever to the taxpayer. Conversely, where the debt actually became worthless in a year later than the year chosen by the taxpayer, the 3-year statute of limitation may operate against the Government. To relieve this inequitable situation, the bill replaces the present 3-year statute of limitations in such cases with a 7-year statute, giving a considerably greater flexibility to the allowance of bad debt deductions in the proper year.

H.R. Rep. No. 2333, 77th Cong., 1st Sess. 44-45 (1942-2 Cum. Bull. 372, 408) (emphasis added).

Although the sentence in the above text beginning with "Conversely" does give the court pause, the reference to a situation where "later evidence" reveals to a taxpayer that a debt had previously become worthless does support the defendant's reading of the

section 6511(d)(1), that it only applies where the bad debt deduction is newly discovered or increased. It is true, as the plaintiffs point out on page 14 of their rebuttal brief, that this excerpt does not refer to a situation where a bad debt is later increased or later decreased. However, the import of the quoted text is that the extended limitations period was intended to cover situations where the taxpayer becomes aware of the availability of a bad debt deduction at some point after the original filing.

The House report indicates that the extended limitations period was enacted to protect taxpayers in those situations where uncertainty concerning the time at which a debt becomes worthless could hamper their ability to

claim refunds relating to bad debt deductions within the limitations period. As the court in Armstrong v. United States, 681 F.2d 774, 776 (Ct.Cl. 1982), noted, "The 7-year period was designed to prevent possible prejudice to those taxpayers whose otherwise legitimate deduction might be placed in jeopardy by the general 3-year period." Although the plaintiffs' bad debt deduction was adjusted here, it was only decreased after the original filing, thus, not calling into play this legislative concern. The legislative history thus supports the United States' position; that section 6511(d)(1) applies only in those situations where the taxpayer's bad debt deduction is increased or discovered after an original filing.

The plaintiffs attempt to recast the defendant's position as a requirement that the NOL carryback must be attributable to the bad debt deduction alone, and the plaintiffs maintain that this position is refuted by section 6511(d)(1) as well as applicable Treasury regulations. They cite the last sentence of section 6511(d)(1), which provides that claims for credit or refund are limited "to the extent of the amount of overpayment attributable to the deductibility of items described in this paragraph [bad debts and worthless securities]." The plaintiffs also quote Treas. Reg. § 301.6511(d)-1(a)(4) (amended by T.D. 6425, 1959-2 C.B. 384), which provides:

> If the claim involves an overpayment based not only on the deductibility of items described in subparagraph (1) of this paragraph [bad debts

> and worthless securities] but also on other items, and if the claim with respect to any items is barred by the expiration of any applicable period of limitation, the portion of the overpayment attributable to the items not so barred shall be determined by treating the allowance of such items as the first adjustment to be made in computing such overpayment.

The plaintiffs maintain that the last sentence of section 6511(d)(1) and the accompanying regulation provide a "sorting mechanism" in the statute, whereby a taxpayer who has both deductible items which are barred on limitations grounds from carryback and bad debt deductions which can be carried back under the seven year period "will only be entitled to utilize the seven-year period of limitation with respect to the portion of the NOL attributable to the bad debt deduction." Opposition Brief, p. 22.

The statute and the regulation thus contemplate that a NOL may be comprised of more than just a bad debt deduction, which is discordant with the plaintiffs' characterization of the defendant's position.

The defendant does not, however, maintain that a taxpayer's NOL carryback must be attributable to a bad debt deduction alone, see Defendant' [sic] Reply to Plaintiff's Memorandum in Opposition to Partial Dismissal ("Reply Brief"), p. 5. Their position is rather that the overpayment for which a refund may be sought under section 6511(d)(1) is only on account of the effect of the deductibility of a bad debt "on the application to a taxpayer of a carryback" when that bad debt deduction is increased over the amount of the bad debt deduction

originally reported; otherwise, the claim for refund is merely on account of the taxpayer's taking of a carryback. That a taxpayer might have other deductions which contributed to a NOL does not affect the defendant's interpretation of the statute (the key is what happens to the bad debt deduction), and the last sentence of the statute as well as the accompanying regulations are thus consistent with the United States' position.

The plaintiffs attempt to support their interpretation by advancing the text of section 6511(d)(2)(A)(ii), which specifically provides that it applies "with respect to an overpayment attributable to the creation of, or an increase in" a NOL carryback. The plaintiffs also cite the accompanying legislative history, which likewise

provides that "The amendments apply only to that portion of the overpayment for any taxable year which is attributable to the creation of, or an increase in" a NOL carryback. S. Rep. No. 663, 86th Cong., 1st Sess. 622, 623, reprinted in 1959 U.S. Code Cong. & Admin. News 2591, 2592. The argument that the plaintiffs make is that "[i]f Congress had the same concern when it drafted Section 6511(d)(1) as it had when it drafted Section 6511(d)(2)(A)(ii), it would have included similar or identical restrictive language." Opposition Brief, p. 18. The reference to the text and legislative history of section 6511(d)(2)(A)(ii) is thus made to show that the omission of language explicitly requiring the bad debts at issue to be newly discovered or

increased means that such requirements do not apply in section 6511(d)(1).

If both of these sections were drafted concurrently and related to the same subject, the plaintiffs' argument might have some force. However, as the defendant argues, [t]he enactment of a different provision fourteen years later [the language in (d)(2) upon which plaintiffs rely was added in 1959; the language in (d)(1) relating to the interaction of bad debts and NOLs was added in 1945], and relating to the effect of a totally different type of tax attribute -- the elimination of previously accrued income -- cannot reasonably be argued to bear on Congressional intent behind Section 6511(d)(1)." Reply Brief, p. 9.

What little case law there is on this issue supports the defendant's

interpretation of section 6511(d)(1). The defendant cites Armstrong, in which the court rejected the position there advanced by the government that "section 6511(d)(1) only applies after the NOL period has expired." Id. at 778. However, the court adopted the position which the United States advances here, that the seven-year limitations period applies in those situations where the bad debt deduction is newly discovered or increased. The Armstrong court made the following ruling:

> Finally, the alleged overpayments for the years 1972 and 1973 are not "on account of" the deductibility of a bad debt - plaintiffs took a bad debt deduction in 1975 which has not been contested. Rather, plaintiffs' overpayment resulted from the failure to utilize the NOL carryback provisions (section 172) within the time allotted

> under statute. The proper provision to be considered, then, is the NOL limitation period specified in section 6511(d)(2)(A), not the bad debt limitation period of section 6511(d)(1). If the real basis for the claim for refund was a redetermination of the bad debt deduction itself, then any effect on an existing or newly created carryback would invoke the 7-year period of section 6511(d)(1).

Armstrong, 681 F.2d at 778 (footnote omitted). As in Armstrong, the NOL carryback in this case is not "on account of" the deductibility of a bad debt; since the plaintiffs' original filing, the only adjustments to that deduction were downward. They thus could not have generated the belated attempt to carryback a NOL.

The plaintiffs challenge Armstrong as inconsistent with another decision by the Court of Claims in Smith Electric Co. v. United States, 461 F.2d

790 (Ct.Cl. 1972).5/ The plaintiffs refer to the Brief for the United States in establishing that the situation of the Smith Electric taxpayer is similar to that of the plaintiffs. The Smith Electric taxpayer added a sum to its bad debt reserve on its 1960 return, the amount of which was not later changed. Approximately six years later, the taxpayer filed refund claims for 1957 and 1958 which arose from a NOL for

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5/The plaintiffs criticize Armstrong for being decided by only a three judge panel, whereas there were six judges on the Smith Electric panel. The plaintiffs also note that the Armstrong court criticized the taxpayer in that case for raising its section 6511(d)(1) argument for the first time in its brief. Although this court is not bound by the decisions of the court of claims, neither of these contentions provides the court with a meaningful basis for discounting the opinion in Armstrong.

1960 as a result of the bad debt deduction. While the facts of that case are in relevant respects similar to those of the plaintiffs here, the limitations question at issue here was simply not addressed by the Smith Electric court. In the words of the Smith Electric court:

> The sole issue in this case is whether the special seven-year statute of limitations, with respect to filing claims for refund on account of the deductibility of a worthless debt, is applicable to taxpayers on the reserve method as well as to those on the direct charge-off method.

Smith Electric, 461 F2d at 791 (Footnote omitted). Since Smith Electric was concerned with a different issue, it does not assist in this court's analysis.

The defendant also draws support for its position from Revenue Ruling

55-523, 1955 Cum. Bull. 497. "Since revenue rulings are to be given weight by the courts, McMartin Industries, Inc. v. Vinal, 441 F.2d 1274, 1275-76 (8th Cir. 1971), we must closely analyze the ruling." Carle Foundation v. United States, 611 F.2d 1192, 1195 (7th Cir. 1979), cert. denied, 449 U.S. 824, 101 S.Ct. 85 (1980). Revenue Ruling 55-523, which advances the defendant's interpretation of section 6511(d)(1), provides in part that:

> Where a taxpayer sustains a net operating loss for a taxable year, but does not file a claim for refund with respect to any overpayment of tax resulting from the carryback of such loss within the statutory period prescribed in section 6511(d)(2)(A) of the Internal Revenue Code of 1954, no refund with respect thereto can be allowed. However, where an additional bad debt or loss on worthless securities is determined for such loss year, the effect of

> which is to increase the net operating loss, section 6511(d)(1) of the Code provides that a claim for refund may be filed with respect to such bad debt ... within 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback.

The plaintiffs' position, that section 6511(d)(1) should apply even where a bad debt deduction has decreased, thus having a negative (if any) effect on a NOL, conflicts with this revenue ruling.

In light of the above discussion, the court agrees with the defendant's interpretation of section 6511(d)(1) and finds that this provision does not apply to the plaintiffs in this case. Rather, the plaintiffs' claims for refund for 1970 and 1967 are governed by sections 6511(d)(2)(A) and (4)(A), and are therefore untimely.

The plaintiffs make one alternative argument. They note that in November, 1975, The Indiana National Bank and the Internal Revenue Service executed Form 872-B, Consent Fixing Period of Limitations Upon Assessment of Miscellaneous Excise Taxes ("the Consent"), for the period running from January 1, 1972, to December 31, 1973. "The Consent, which related to excise taxes imposed by Section 4251, extended the statutory period of limitations for assessment of tax for calendar years 1972 and 1973 to December 31, 1977." Opposition Brief, p. 32 (emphasis added).

Section 6511(c) contains special rules regarding time limitations on credit or refund claims in the situation where "an agreement ... extending the period for assessment of

a tax imposed by this title is made within the period prescribed in subsection (a) for the filing of a credit or refund...." (The Consent was clearly executed within this time frame.) In the case of such agreements "the period for filing claim for credit or refund ... shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof...." Section 6511(c)(1). The plaintiffs claim that under this provision, their refund claims for 1967 and 1970, filed on September 15, 1977, were timely.

However, as the defendant pointed out, the Consent upon which the plaintiffs rely was expressly limited to the assessment of excise, not income

taxes. As the defendant persuasively argues,

> Section 6511(c) is traceable to Section 322(b)(3) of the 1939 Code, added by the Revenue Act of 1942.... The House Report observes: "[i]t seems only proper that if the Government is given the right by waiver to make assessment for the taxable year after the period for assessment has expired, the taxpayer should also have the right to additional time for filing refund claims for the same year." H.R. Rep. No. 2333, supra, 1942-2 Cum. Bull. at 414.

Since the extension of time provided for in section 6511(c) is predicated on notions of reciprocity between the government and the taxpayer, no reason exists here for extending the limitations period for the filing of income tax claims when only the period for assessment of excise taxes was explicitly extended by the parties in the Consent.

The plaintiffs argue that section 6511(c) applies broadly to "a tax imposed by this title." Title 26. However, the fact that section 6511(c) contained general terms did not prevent the parties here from entering into an agreement relating to a specific type of tax. Surely the plaintiffs' protests would have been great here if the Internal Revenue Service had attempted to use the Consent in order to assess additional income tax. Since the Consent was limited by its terms to the assessment of excise taxes, and since the legislative history clearly shows that the intent of section 6511(c) was to establish a certain parity between the government and taxpayers, the court agrees with the defendant that the scope of the extended limitations period is defined

by the scope of the Consent. Accordingly, the court finds that special limitations period in section 6511(c) does not apply to the plaintiffs' claims.

III. Conclusion

Since the court finds that the plaintiffs' claims for refund for the years 1967 and 1970 were not timely filed, the court hereby grants the defendant's motion for partial dismissal.

It is so ORDERED this 25th day of July, 1991.

SARAH EVANS BARKER, JUDGE
United States District
Court, Southern District
of Indiana

REJ:2533:cp

APPENDIX III

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

INDIANA NATIONAL CORPORATION and subsidiaries,	)	
Plaintiff,	)	
v.	)	Civil No. 88-277-C
UNITED STATES OF AMERICA,	)	
Defendant.	)	

FINAL JUDGMENT

By Entry dated July 25, 1991, this Court granted the defendants' motion for partial dismissal, dismissing plaintiff's income tax refund claims for the years 1967 and 1970 for lack of jurisdiction. With respect to claim for the year 1973, the parties agree that the Court has jurisdiction and further agree, by the signatures of their counsel on the following page, that the plaintiff overpaid its

1973-year corporate income tax by $20,918. This agreement is without prejudice to the plaintiff's right to appeal the dismissal of the claims with respect to 1967 and 1970. Accordingly, it is hereby

ORDERED, ADJUDGED AND DECREED that the plaintiff has overpaid its 1973-year corporate income tax in the amount of $20,918, which overpayment, together with statutory interest, shall be credited or refunded in accordance with law.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the plaintiff is entitled to nothing further by way of its complaint for the reasons indicated in the July 25, 1991 Entry.

SO ORDERED this 13th day of November, 1991.

SARAH EVANS BARKER, JUDGE
United States District Court
Southern District of Indiana

The parties agree to the entry of the foregoing judgment.

For the Plaintiff:

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For the Defendant:

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REJ:2533:cp

APPENDIX IV

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

INDIANA NATIONAL CORPORATION AND ITS SUBSIDIARIES: INDIANA NATIONAL BANK, INDIANA REALTY, INC., INDIANA NATIONAL NETWORK CORP., INDIANA MORTGAGE CORP., CONSUMER MARKETING SERVICES, INC., TOWER AGENCY, INC. INDIANA NATIONAL OVERSEAS CORP., TFAC, INDIANA NATIONAL LEASING, INC. AND CITADEL FINANCE, INC.	)	
Plaintiffs,	)	
v.	)	CIVIL ACTION NO.
UNITED STATES OF AMERICA,	)	IP88 277C
Defendant.	)	

COMPLAINT

Come now the plaintiffs, Indiana National Corporation and its Subsidiaries: Indiana National Bank, Indiana Realty, Inc., INB International, Inc., Indiana Mortgage

Corp., Consumer Marketing Services, Inc., Tower Agency, Inc., Indiana National Overseas Corp., TFAC, Indiana National Leasing, Inc. and Citadel Finance, Inc. (hereinafter collectively referred to as the "plaintiffs"), by their attorneys, Robert E. Johnson, Stephen D. Smith and Lisa A. Lutz and for their cause of action against the defendant, allege and say as follows:

1. This is an action instituted pursuant to and jurisdiction arises under the provisions of 28 U.S.C. Section 1346(a)(1) for the recovery of Federal Internal Revenue corporate income taxes and interest for the calendar years 1973, 1970 and 1967.

2. Plaintiffs are affiliated corporations which filed consolidated Form 1120 income tax returns with the Internal Revenue Service and their

principal places of business are at One Indiana Square, Indianapolis, Indiana 46266 with principal business activities as follows:

Names of Plaintiffs	Principal Business Activity
Indiana National Corporation	Holding Company
Indiana National Bank (formerly The Indiana National Bank of Indianapolis)	Banking
Indiana Realty, Inc.	Real Estate
Indiana National Network Corp. (formerly INB International Inc.)	Electronic Funds Transfer Services (formerly Customs Brokerage)
Indiana Mortgage Corp	Mortgage Services
Consumer Marketing Services, Inc.	Marketing Services
Tower Agency, Inc.	Insurance Agency
Indiana National Overseas Corp.	Holding Corp., Foreign Bank Stock
TFAC (formerly, Tower Finance & Accept. Corp.)	Consumer Installment Loans
Indiana National Leasing, Inc.	Leasing
Citadel Finance, Inc.	Direct Consumer Financing

3. The Indiana National Bank of Indianapolis timely filed its Form 1120 corporate income tax return for 1967 with the Internal Revenue Service, and plaintiffs timely filed their Form 1120 corporate income tax returns for 1970 and 1973 with the Internal Revenue Service, and paid the taxes shown thereon in the respective amounts of $2,658,232.36, $1,983,052 and $195,154.

4. On June 11, 1971, the District Director of Internal Revenue Service, Indianapolis, Indiana, sent Indiana National Bank of Indianapolis a 30-day letter containing income tax examination changes for 1967 proposed by a revenue agent which were agreed to as follows:

Taxable income reported on return	$6,314,771.53

Plus: Additional income and unallowable deductions:			
(a)	Bad debts	$56,690.61	
(b)	Software expense	12,000.00	
(c)	Amortization of mortgage service contracts	697.64	
(d)	Miscellaneous	30,000.00	
(e)	Depreciation--Jefferson National Bldg.	6,238.77	
(f)	Proceeds from insurance	7,256.81	
			112,883.83
Subtotal			$6,427,655.36
Less: Nontaxable income and additional deductions:			
(g)	Amortization of software	2,000.00	
(h)	Depreciation	1,028.80	(3,028.80)
Corrected Taxable Income			$6,424,626.56

As a result of the above adjustments, The Indiana National Bank of Indianapolis paid to the Internal Revenue Service on June 16, 1971 additional Federal income tax for 1967 in the amount of $52,730.41 together with interest in the amount of $9,431.22, or a total payment of $62,161.63.

5. On or about March 6, 1974, the plaintiffs filed Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, and made payment on March 5, 1974 to the Internal Revenue Service of $125,000 with respect to the calendar year 1973.

6. On or about May 30, 1974, the plaintiffs filed with the Internal Revenue Service Form 7005, Application for Additional Extension of Time to

File Corporation Income Tax Return, and made payment on June 14, 1974 of $125,000 with respect to the calendar year 1973.

7. The Form 7005 was returned to the plaintiffs with an endorsement dated June 6, 1974 from the Internal Revenue Service granting the additional extension to September 15, 1974, and the original Form 7005 was stamped "received" by the Memphis Service Center on June 3, 1974.

8. September 15, 1974 was a Sunday, and on September 16, 1974 the plaintiffs filed with the District Director of Internal Revenue, Indianapolis, Indiana, their Form 1120, U. S. Corporation Income Tax Return, claiming a refund of corporate income taxes of $54,879, having previously paid $250,033 in corporate income taxes.

9. Plaintiffs' 1973 return claimed bad debts originally of $6,038,574 as follows:

Indiana National Bank	$5,894,396
Indiana Mortgage Corp.	$103,294
Consumer Marketing Service, Inc.	$35,000
TFAC, Inc.	$2,718
Citadel Finance, Inc.	$3,167

10. Plaintiffs' 1973 return reported a net operating loss for the calendar year 1973 of $4,125,569, so that, absent the bad-debt deductions claimed, there would have been no net operating loss for 1973.

11. On September 16, 1974, the plaintiffs filed a Form 1120X, for the calendar year 1970, changing the foreign tax credit election to a per country basis, and the Form 1120X indicates that no tax liability was calculated on the Form 1120X "as the effect of this election will be

included in the offset of the net operating loss carryback from the 1973 return".

12. On December 31, 1974, the plaintiffs filed with the District Director of Internal Revenue, Indianapolis, Indiana, a Form 1120X amended return for the calendar year 1973 amending, among other things, the following items:

(a) The bad debt deduction was reduced by the amount of $162,218 "to agree with 1972 RAR (in progress)".

(i) One adjustment was attributable to reduction in the eligible loans outstanding of the Indiana National Bank at the end of the calendar year 1972 from $768,062,650 to $742,061,324. In addition, the experience ratio was amended from .3456% to .34999032715% This resulted in a decrease in the 1973 bad debt

deduction of the Indiana National Bank of $137,873.

(ii) The "reserve balance" for the Indiana Mortgage Corporation was "adjusted to agree with 1972 RAR (in progress)" from $183,280 to $121,647 resulting in a decrease in the subsidiary's 1973 bad debt deduction of $24,345.

(b) Additional adjustments were made on the Form 1120X for the calendar year 1973 with respect to:

(i) Amortization;

(ii) Depreciation;

(iii) Interest expense; and

(iv) Corrected schedule of partnership ordinary gains/losses.

13. On December 31, 1974, a Form 1139 was filed for the calendar year 1973 by the plaintiffs with the District Director of Internal Revenue Service, Indianapolis, Indiana,

claiming refunds for the calendar years 1970 and 1971 in the respective amounts of $976,764 and $89,819, said refunds being attributable to a net operating loss of $4,635,548 and an unused investment credit of $193,202.

14. The net operating loss figure, on the plaintiffs' Form 1139 reflected an increase from the original net operating loss for 1973 of $509,979, and this increase was attributable to the Form 1120X filed December 31, 1974 for the calendar year 1973 and the decrease in bad-debt deductions and increases in other deductions referred to in paragraph 12 above.

15. On December 31, 1974, the plaintiffs' Form 1139 carrying back the unused investment credit of $971,297 from the calendar year 1970 to the

calendar year 1967 was filed with the District Director of Internal Revenue, Indianapolis, Indiana.

16. On January 7, 1975, the plaintiffs filed with the District Director of Internal Revenue Service, Indianapolis, Indiana, a Form 1120X amended return for the calendar year 1973 claiming a refund of $8,780, and this amended return was filed because the Form 1120X filed December 31, 1974, was incomplete and contained a typographical error.

17. The Indiana National Bank and the Internal Revenue Service, through their authorized representatives, on the respective dates November 4, 1975 and November 5, 1975 executed a Form 872-B, Consent Fixing Period of Limitations Upon Assessment of Miscellaneous Excise Taxes, for the

period January 1, 1972 through December 31, 1973 and extending the statutory period of limitations to December 31, 1977.

18. On June 1, 1976, the plaintiffs filed with the District Director of Internal Revenue Service, Indianapolis, Indiana, a Form 1120X amended return for the calendar year 1970 eliminating the foreign tax credit ("FTC") carryback from 1972 due to plaintiffs' amended 1972 return of 12/2/75 and increasing the usability of investment tax credit carryback from 1972 due to decrease in FTC allowable.

19. On September 15, 1977, the plaintiffs filed a Form 1120X for 1973 with the District Director of Internal Revenue Service, Indianapolis, Indiana, claiming a net operating loss in the amount of $4,098,674. A copy of the

plaintiffs' 1973 Form 1120X claim for refund of corporate income tax of $17,662 is attached hereto as Exhibit A.

20. On September 15, 1977, the plaintiffs filed a Form 1120X for the calendar year 1970 with the District Director of Internal Revenue Service, Indianapolis, Indiana, carrying back the net operating loss from 1973 per the Form 1120X filed September 15, 1977, in the amount of $4,098,674 from the calendar year 1973 thus reducing the plaintiffs' tax for 1970 from $1,108,872 to $100,598, thereby generating the claim for refund of $1,008,274. A copy of the plaintiffs' 1970 Form 1120X claim for refund of corporate income tax of $1,008,274 is attached hereto as Exhibit B.

21. On September 15, 1977, the plaintiffs filed a Form 1120X for the

calendar year 1967 with the District Director of Internal Revenue Service, Indianapolis, Indiana, showing a recomputation of the tax to reflect an investment tax credit carryback from 1970 to 1967 as a result of the net operating loss carryback from 1973 to 1970. A copy of the plaintiffs' 1967 Form 1120X claim for refund of corporate income tax of $862,466 is attached hereto as Exhibit C.

22. On July 18, 1979, the District Director of Internal Revenue Service, Indianapolis, Indiana, sent the plaintiffs a 30-day letter containing the income tax examination changes proposed by revenue agent David E. Laird in his Form 4549-A dated October 18, 1978 covering the calendar years of the plaintiffs 1967, 1970, 1973 and 1974. This letter proposed

overpayments for 1967, 1970 and 1973 in the respective amounts of $671,761, $802,344 and $20,918, and a deficiency for 1974 in the amount of $92,863. Among the adjustments proposed in the revenue agent's report were adjustments to bad-debt deductions relating to the subsidiary, The Indiana National Bank, in the amount of $135,464 for 1973 and an additional bad-debt deduction of $10,216 for 1974, Indiana Mortgage Corporation for 1973 and 1974 in the respective amounts of $103,294 and $35,945 and for T.F.A.C., Inc. for 1974 in the amount of $122,183.

23. On November 16, 1979, the plaintiffs filed a protest to the July 18, 1979 30-day letter of the District Director. Among other items, the protest placed in issue the adjustments with regard to bad debts of Indiana

Mortgage Corporation for 1973 and 1974 in the respective amounts of $103,294 and $35,945 and T.F.A.C., Inc. for 1974 in the amount of $122,183.

24. 26 U.S.C. Section 6511(c), with respect to time limitations on credit or refund, provides special rules applicable in case of extension of time by agreement as follows:

> (c) Special rules applicable in case of extension of time by agreement.--If an agreement under the provisions of section 6501(c)(4) extending the period for assessment of a tax imposed by this title is made within the period prescribed in subsection (a) for the filing of a claim for credit or refund--
>
> (1) Time for filing claim.--The period for filing claim for credit or refund or for making credit or refund if no claim is filed provided in subsections (a) and (b)(1), shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof under section 6501(c)(4).

> (2) Limit on amount.--If a claim is filed, or a credit or refund is allowed when no claim was filed, after the execution of the agreement and within 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof, the amount of the credit or refund shall not exceed the portion of the tax paid after the execution of the agreement and before the filing of the claim or the making of the credit or refund, as the case may be, plus the portion of the tax paid within the period which would be applicable under subsection (b)(2) if a claim had been filed on the date the agreement was executed.

25. 26 U.S.C. Section 6511(d)(1) provides a seven-year period of limitations for bad debts and worthless securities as follows:

> (d) Special rules applicable to income taxes.--
>
> (1) Seven-year period of limitation with respect to bad debts and worthless securities.--
> If the claim for credit or refund relates to an

overpayment of tax imposed by subtitle A on account of--

> (A) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section 165(g), of a loss from worthlessness of a security, or
>
> (B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover,

in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such

> carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later. In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

26. Following the filing of plaintiffs' protest, numerous conferences with the Internal Revenue Service Appeals Division were held. On August 10, 1983 plaintiffs' counsel, at the request of the Internal Revenue Service, filed with the Internal Revenue Service a supplemental letter setting forth plaintiffs' position on a statute of limitations question raised by the Internal Revenue Service in 1983. A copy of plaintiffs' August 10,

1983 letter is attached hereto as Exhibit D.

27. The Internal Revenue Service has negotiated a settlement with the plaintiffs with respect to the issues raised in plaintiffs' protest for 1973 and 1974 and other years 1975, 1976, 1977 and 1978. This settlement is reflected in a Form 906 Closing Agreement on Final Determination Covering Specific Items signed by authorized representatives of plaintiffs on April 1, 1987 and the Internal Revenue Service on February 25, 1987, although the amounts of refund of corporate income tax plus interest for 1977 and deficiency in corporate income tax plus interest for 1978 was not corrected by the Internal Revenue Service Center until 1988. A copy of the Form 906 is attached hereto

as Exhibit E.

28. Plaintiffs have not received a statutory notice of claim disallowance for the calendar years 1967, 1970 and 1973 as provided under 26 U.S.C. Section 6532(a)(1).

29. Therefore, the plaintiffs overpaid their Federal Internal Revenue corporate income taxes for the calendar years 1967, 1970 and 1973 in the respective amounts of $862,466, $1,008,274 and $17,662, which amounts, together with interest as provided by law, are due and owing to the plaintiffs from the defendant.

30. Plaintiffs are the sole owners of the aforesaid claims for refund and have made no assignment of said claims.

WHEREFORE, plaintiffs pray that judgment be entered in their favor in

the total amount of $1,888,402, together with interest as provided by law, and that the Court grant such other relief as it may deem proper and that the plaintiffs be awarded their reasonable attorneys' fees and litigation costs pursuant to 26 U.S.C. Section 7430.

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REJ:2533:cp

EXHIBIT D

August 10, 1983

Mr. Joseph Parker
Appeals Division
Internal Revenue Service
575 North Pennsylvania, Room 595
Indianapolis, Indiana 46244

Re: Indiana National Corporation and Subsidiaries 1970 Claim for Refund filed September 15, 1977 Based on Bad-Debt Deductions for 1973 and 1973 Net Operating Loss Carryback

Dear Joe:

At our settlement conference, you indicated you had an earlier communication from the District Counsel concluding that the statute of limitations did not bar the 1970 claim for refund filed September 15, 1977 based on bad-debt deductions for 1973 and 1973 net operating loss carrybacks to the calendar year 1970. Further, you asked if I would review my files

with regard to our position on this statute of limitations question originally considered by the examining revenue agents, by us and ultimately by the Internal Revenue Service's District Counsel. In addition, you asked me to comment on the 1982 case of C. E. and C. W. Armstrong v. United States, (Ct Cl. 1982) 681 F.2d 774, which discussed Section 6511(d)(1) of the Internal Revenue Code seven-year bad-debt statute of limitations but which did not cite the previous leading case from the same Court of Claims, Smith Electric Company, Inc. v. Untited States, (Ct.Cl. 1972) 461 F.2d 790, which also dealt with the special seven-year statute of limitations.

In going back over my papers, I find that apparently this matter initially was called to my attention,

and I met on December 7, 1978 with Revenue Agents David Laird and Mark Nolen and Group Supervisor Frank Urban. Later, my notes show that I met with Revenue Agent Larry Miller and Group Supervisor Frank Urban on March 28, 1979 and was advised on June 20, 1979 by Charles E. Husman, Tax Manager of the taxpayers, that the District Counsel had agreed with our letter dated April 11, 1979 to Charles Husman that the 1970 claim for refund filed September 15, 1977 was not barred by the statute of limitations. A copy of the April 11, 1979 letter is attached hereto as Exhibit A for your information. During this time period, in addition to the main argument under Smith Electric Company, Inc., supra, we discussed various alternative positions, and you asked that we advise

you, not only of our main reliance on Smith Electric Company, Inc. but also as to the alternative positions taken.

* * *

II. Taxpayers Main Position Supported by two Court of Claims Cases, Smith Electric Company, Inc. v. The United States, Decided in 1972 and C. E and C. W. Armstrong v. The United States, Decided in 1982

A. Smith Case

Preparatory to discussing the above two cases, I obtained copies of the briefs filed in the last of the above two cases which has delayed this presentation. In discussing the earlier case of Smith Electric Company with the revenue agents, the group supervisor and the District Counsel's office, we had understood that the Review Division in Cincinnati had initially sent our taxpayers' case back

raising the statute of limitations question because they felt our case was distinguishable from the Smith Electric Company case on the ground that, in Smith Electric Company, the bad-debt deduction of $81,943.79 constituting an addition to the reserve for bad debts had not been claimed in the 1960 return of Smith Electric. At that time we questioned this interpretation of Smith Electric Company by the Cincinnati Review Division and I first talked to the attorney in New Haven, Connecticut, who had represented Smith Electric Company to determine whether or not such deduction had been shown in the original 1960 return or had later been an additional bad-debt deduction claimed in a subsequent claim for refund which the reviewer in Cincinnati seemed to think had taken place. On

April 4, 1979, I did talk to the attorney in the Smith Electric Company case and he orally indicated that the bad-debt deduction involved of $81,943.79 had been included on the original 1960 income tax return of Smith Electric and this was confirmed when I received a copy of the Form 1120 Corporate Income Tax return for 1960 of Smith Electric Company, Inc. indicating on line 14, Schedule F, the $81,943.79 deduction for bad debts and setting forth in Schedule F the manner in which this deduction was computed.

A copy of the Form 1120, 1960 income tax return of Smith Electric, is attached hereto as Exhibit B and was made available to the revenue agents, their group supervisor and district counsel's office. To elaborate a little on the Smith Electric Company,

Inc. case, the United States contended that the taxpayer, Smith Electric, under the reserve method, could support its addition to its reserve by relying on past experience with accounts as a composite and that the taxpayer might make adjustments in later years to reflect an inadequacy in the reserve. The Court of Claims agreed this was true with respect to the total reserve balance but indicated that the United States contention was erroneous with reference to specific bad debts charged against the reserve which had become worthless during a preceding taxable year. The Court of Claims concluded that the taxpayer, Smith Electric, could not make this adjustment in some later year and that the taxpayer was permitted to charge worthless accounts against the reserve only in the year

they became worthless.

In response to this position of the taxpayer, Smith Electric, the United States suggested that the taxpayer's remedy was to increase the addition to the reserve in the taxable year in which it discovered the inadequacy of its estimate, but the Court of Claims concluded this would lead to an absurd result and did not subscribe to such a rule of law but instead found that if the debt became worthless in one year that should be the only year in which it could be charged against the reserve.

After this reasoning, the Court of Claims in the Smith Electric Company case stated that Congress had seen fit to grant a special seven year statute of limitations with respect to bad debts and that Section 6511(d)(1)(A)

refers to any debts under Section 166, not just those deductible under Section 166(a), which relates to the direct charge-off method. The Court of Claims then concluded there was nothing in the statute of limitations itself or in the legislative history to indicate that this special statute of limitations is to be limited to taxpayers utilizing the direct charge-off method. Thus, the Court of Claims concluded based on the findings of facts as stimulated by the parties, that the Smith Electric Company's claims for refund for the years 1957 and 1958 were not barred by the statute of limitations where they related to a net operating cost carryback from 1960 and the taxpayer filed claims for refund under the seven year statute on March 11, 1966 which was more than three years after the

date on which the 1960 return of Smith Electric was filed. In the Smith Electric Company case, the Court of Claims rejected the same argument that was made by the Cincinnati IRS reviewer in our taxpayer's case, namely, in the Smith Electric Company case that the claims were not allowable on the ground that they were not filed within the three-year limitation period of Section 6511 of the Internal Revenue Code of 1954, which would have run March 15, 1964. Instead, the Court of Claims held in the Smith Electric Company case that the special seven year statute of limitations with respect to filing claims for refund by Smith Electric Company, Inc. was applicable and the March 11, 1966 filing was within the seven year statute of limitations. Based on this analysis contained in the

letter submitted to the Internal Revenue Service, Exhibit A, it is understood that the District Counsel's office agreed with our main position and so notified our taxpayers in June, 1979.

B. Armstrong Case

Turning now to the 1982 opinion in the Armstrong case, supra, surprisingly, the primary difference between the Smith case and the Armstrong case is not on the facts but rather on the issues raised and the manner in which the Court of Claims handled these issues. The Armstrong case did not refer to the Smith case. In the Armstrong case, the Armstrongs incurred a net operating loss for the calendar year 1975 and filed their 1975 return on October 13, 1976, after first obtaining an extension. On October 15,

1979, the Armstrongs filed amended returns for the years 1972 and 1973 and sought refunds of $12,579 and $916, respectively, attributable to the carryback of the net operating loss from 1975. The Internal Revenue Service disallowed both claims on the ground that recovery was barred by the statute of limitations set out in Section 6511 of the Internal Revenue Code. The Court of Claims stated that the sole issue before the court was whether the plaintiffs timely filed claims for refund for 1972 and 1973 and considered Armstrong's argument that the Internal Revenue Service erroneously interpreted Section 6511(d)(2)(A) by failing to include the extensions of time granted for filing the 1975 return in the computation of the limitation period. The Court of

Claims held this argument was clearly without merit, as no statutory basis existed for such an application. The defendant in the Armstrong case, the United States, made a motion to dismiss on the grounds that the claims for refund were not timely filed and the Court of Claims emphasized that the Armstrongs' response to the defendant's motion to dismiss, for the first time, raised the proposition that the governing statute was Section 6511(d)(1) which provides a seven year period of limitations for bad debts and worthless securities. In this regard, the Armstrongs' new claim was that the net operating loss carried back in 1975 came as a result of a bad-debt deduction (Section 166(a)) taken by a partnership in which the Armstrongs had an interest.

The Court of Claims noted that the pertinent part of Section 6511(d)(1) stated: "If the claim for * * * refund relates to an overpayment on account of the effect that the deductability of such a debt * * * has on the application to the taxpayer of a carryback, the period shall be either seven years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of the subsection [the general NOL provisions, discussed earlier], whichever expires the later."

The United States then argued that three facts made the special bad-debt limitation period inapplicable to the Armstrong case:

(1) The Armstrongs made a determination that the bad

debt became worthless in 1975 and reported the deduction on their 1975 return;

(2) At the time of the filing of their 1975 return, the Armstrongs knew that the bad-debt deduction contributed to an NOL which was available for carryback to 1972 and 1973; and

(3) At the time of filing their 1975 return, the Armstrongs had 30 months [sic] (until April 15, 1979) in which to file timely claims for refund for 1972 and 1973 relating to the carrybacks from the 1975 NOL.

The Court of Claims in discussing the legislative history of Section 6511 held that the seven year statute of

limitations period applicable to bad debts did not allow the Armstrongs to claim, in 1979, the carryback of their 1975 loss to 1972 and 1973 noting that the alleged overpayments for the years 1972 and 1973 were not "on account of" the deductability of a bad debt where the Armstrongs took a bad-debt deduction in 1975 which was not contested. Under these circumstances, the Court of Claims held that the Armstrong's overpayment resulted from the failure to utilize the net operating loss carryback provisions (Section 172) within the time alloted under the statute of limitations and therefore, the proper provision to be considered, then, is the net operating loss limitation period specified in Section 6511(d)(2)(A), not the bad-debt limitation period of Section

6511(d)(1). The court, in coming to this conclusion, as part of its holding, noted that if the real basis for the claim for refund had been a redetermination of the bad-debt deduction itself, then any effect on an existing or newly-created carryback would invoke the seven-year period of Section 6511(d)(1).

C. Differences

There are significant differences between the Smith case and the Armstrong case as they relate to the particular facts of our taxpayers' case. Some of the differences are here listed:

1. The Smith case was held before six judges of the Court of Claims, including the chief judge and the Armstrong case, on the other hand, was held before only three judges.

Significantly, Judge Kashiwa participated in both opinions; however, he did not write either opinion and yet the Armstrong case opinion nowhere referred to the Smith case.

2. The Smith case rationale on the special bad-debt seven-year statute of limitations has been cited with approval in Winter & Hirsch v. U. S., 571 F.2d 11 (Ct.Cl. 1978) and other cases have cited the Smith case. However, we found not one single case that has cited and followed the rationale on the special bad-debt seven-year statute of limitations contained in the Armstrong case and further the Armstrong case did not purport to overrule or even discuss or refer to the Smith case.

3. In the Smith case, the taxpayer's net operating loss was

primarily attributable to a bad debt in the form of a worthless note from a trade debtor of the taxpayer with the remainder being attributable to an addition to the taxpayer's reserve for bad debts. As noted above, the Smith taxpayer took the bad-debt deduction on its 1960 return and the stipulation of facts in the Smith case revealed that it was "apparent" to the taxpayer that the debtor was insolvent in 1960; it was in this year that the debtor sold its assets in liquidation and the taxpayer Smith received none of the proceeds. Therefore, it is very clear that the worthless debt conclusively became worthless in 1960 in the Smith case and there was no question or equivocation about when the worthless debt deduction should be taken in the form of an addition to the taxpayer's

reserve for bad debts. This is significant because the Armstrong opinion reflected the Court of Claims refusal to allow the use of the seven year statute of limitations in cases where the taxpayer knows that the debt is worthless in the year of the original return, but is "dilatory" in filing its claim for refund in connection with the net operating loss created by the deduction and files the claim after the three year statute of limitations has expired. In the Smith case there was no argument by the Internal Revenue Service that since the taxpayer knew in 1960 the debt was worthless that the taxpayer Smith should have claimed the operating loss carryback in 1960 as was the United States' argument in the Armstrong case. The United States in Smith

argued that because the taxpayer utilized the reserve method of accounting for bad debts as opposed to the specific charge-off method, it was not entitled to utilize the special seven year statute of limitations.

4. In the Armstrong case, the Armstrongs initially did not claim their right to utilize the special seven year statute of limitations to a bad debt until briefs were actually filed with the Court of Claims. The Court of Claims was displeased with the Armstrongs' raising, for the first time, and at such a late time, their ability to utilize the seven-year statute of limitations on the basis of a bad debt which arose "as a result of a bad-debt deduction taken by a partnership in which the plaintiffs had an interest". Apparently, the

Armstrongs' main argument in their case had been that they should have been able to utilize the new statute of limitations which allowed extensions of time to file to be included within the statute of limitations and this argument was correctly identified by the Court of Claims as incorrect because the amendment of the statute of limitations in the form of Section 6511(d)(2)(A) was not part of the tax law until after the year in issue in the Armstrongs' case.

5. The United States Government made vastly different arguments in the Armstrong case than it presented in the Smith case, as indicated above. The United States' arguments included the argument that the taxpayers determined the debt became worthless in the year it was deducted and then the return

containing the net operating loss was filed and the Armstrongs knew that the bad debt contributed to the net operating loss which was at that time available for carryback to the third and second preceding taxable years and at that time the Armstrongs had "30 months" (sic) to file their claims for refund for the carrybacks of the net operating loss. The Court of Claims agreed with the United States Government argument that the legislative history of the seven-year statute of limitations was intended to cover situations where information obtained subsequent to the filing of an original return results in the redetermination of the year of the deduction for the bad debt. In this regard, the Court of Claims stated, in the Armstrong case, that the taxpayers

who claim a bad-debt deduction on their original return are not at risk under the three-year statute of limitations. This seems to be rather a naive statement since the fact that a taxpayer claims a bad-debt deduction on its return does not mean that it will not be challenged by the Internal Revenue Service as incorrectly taken in that particular year or incorrectly computed.

The purpose of the seven-year statute of limitations, as reflected by the legislative history, is for taxpayers who have previously claimed a bad-debt deduction and have had that bad-debt deduction contested for being taken in the wrong year so that they may have an additional period of time to utilize the deduction which has been challenged by the Internal Revenue

Service. It is interesting to note in the Armstrong case that the United States Government did not challenge the Armstrong taxpayers' claim for the bad-debt deduction and the three-year period for assessment of deficiency had already run. In a footnote, the Court of Claims states that the validity of a bad-debt deduction is a question of fact which can only be decided after an initial determination of the timeliness of the refund claim is made. This does not appear correct. The government does not have to wait until a claim for refund is filed to determine whether or not a bad-debt deduction is properly taken either as to amount or as to the proper taxable year in which the deduction should be taken. The Court of Claims appears to mistakenly believe that the proper time for scrutinizing a

bad-debt deduction is when a claim for refund generated by a bad-debt deduction is filed and therefore the Court of Claims felt that a determination must first be made whether or not the claim for refund has been timely filed and, if it has not, the issue of whether or not the bad-debt deduction is valid is to be decided.

Unlike the Court of Claims opinion in the Smith case, the Armstrong case was concerned that the Armstrongs had been "dilatory" in filing their claim for refund and stated that the special seven year statute of limitations was not designed to provide an extra four year grace period where the Armstrongs had been dilatory. In this regard, the Court of Claims in the Armstrong case emphasized that the basis for its

decision in denying the Armstrongs the use of the seven year statute of limitations seemed to be that the "* * * extended limitation period for bad debts was intended to cover those situations where information subsequent to the filing of the original return results in a redetermination of the year of deduction." It should be noted that the Court of Claims does not mention a redetermination of the amount of the deduction which is equally applicable.

6. The difference between the facts in the Smith case and the Armstrong case on the above point, appear to be indistinguishable which makes the interpretation of these two opinions extremely difficult. In this regard, the taxpayers in the Smith case had taken the full deduction for bad

debts arising in the year of the original return on its original return and the validity of that deduction had not been challenged by the service. The same situation had occurred in the Armstrong case. Significantly, however, in our taxpayers' case the facts are distinguishable from the facts of both Armstrong and Smith on this point and thus the court's reasoning in the Armstrong case is actually favorable to our taxpayers' case for the following reasons, when you consider the facts set forth in the statement of facts contained above in Section I of this letter.

A. The bad-debt deductions taken on the original return for 1973 in our case were adjusted repeatedly as shown in the above Section I statement of facts by

RAR for the preceding year 1972 which was in progress at the time the 1973 Form 1120 was filed. Specifically, adjustments proposed (and accepted for the purposes of filing the Form 1120X amended return on December 31, 1974) reduced the bad-debt deductions taken on the original return in the amount of $162,218. This adjustment was caused by the 1972 RAR in two regards. The first was attributable to the reduction in the eligible loans outstanding at the end of the year an increase in the "experience ratio." This adjustment as noted above resulted in a decrease of the bad-debt deduction with The Indiana National Bank. The second adjustment pertained to the

"reserve balance" for the Indiana Mortgage Corporation.

B. From the statement of facts set forth in Section I above, it is clear therefore that uncertainty did exist with respect to the bad-debt deductions claimed in the original 1973 tax return.

C. The adjustments to the bad-debt deductions were reflected on the Form 1120X filed on December 31, 1974 and the Form 1139 filed also on December 31, 1974 claiming the net operating loss carryback.

D. Not only was the bad-debt deduction for 1973 of our taxpayers amended after the original return was filed but a subsequent examination conducted during 1978 resulted in further

adjustments to the bad-debt deductions of our taxpayers which deductions are still an issue as a result of our protest and are only now apparently being resolved in our discussions of settlement with you.

7. We suggest that, contrary to the Court of Claims reasoning in Armstrong, the fact that a taxpayer claims a bad-debt deduction on the original return is absolutely no guarantee whatsoever that it will not be challenged, subject to a proposed adjustment or otherwise disallowed by the Internal Revenue Service or even amended by the taxpayer itself. Thus, our case, by reason of the developmeents in this regard, shown in Section I of this letter, is vastly stronger than both the Smith and

Armstrong cases because, although over eight years have elapsed since the filing of our taxpayers' original 1973 return, the status of a significant amount of bad-debt deductions are still in question. The Court of Claims rationale in the Armstrong case for disallowing the use of the seven year statute of limitations contained in Section 6511(d)(1) therefore cannot be applied to the facts in our taxpayers' case. Specifically, our taxpayers' case fits within the situations described and critized by the legislative history to the enactment of the seven year statute of limitations. In this regard, and borrowing from the Government's brief in the Smith case, Mr. Randolph Paul, the tax advisor to the Secretary of Treasurery, testified concerning the purpose of the new seven

year statute of limitations under Section 322(b)(5) of the 1939 Code, the predecessor of Section 6511(d)(1) as follows:

> "(c) Statute of limitations on bad debts and worthless stock losses. - the difficulty surrounding the deduction for bad debts and worthless stock losses have long been familiar sources of irritation to taxpayers and the Commissioner alike. It is far from easy to ascertain when a debt is bad or when a share of stock becomes worthless. At the same time, the taxpayer must select the proper year before the statute of limitations has run with respect to that year.
>
> Much litigation is occasioned by the artifical barrier thus thrown up by the statute of limitations, as a taxpayer who chose one year only to be met with the claim that an earlier but barred year was the correct year must battle to defend his choice or lose the deduction entirely.
>
> It is believed that this useless litigation and many of the difficulties in this field can be avoided by, first, eliminating the ascertainment of worthlessness and the charge-off requirements in the case of bad debts -- including

> securities producing capital losses -- and, second, allowing a 7-year statute of limitations with respect to refund claims relating to a deduction on account of these items." House hearings, Committee on Ways and Means, 77th Cong., 2d. Sess., pp. 92-93. (Underlining supplied)

8. Finally, it was significant to know that the United States Government in the Armstrong case relied, in large measure, on Revenue Ruling 55-523, 1955-2 CB 497, which held that where a taxpayer sustains a net operating loss but does not file a claim for refund with respect to overpayment of tax resulting from the carryback of the net operating loss within the time prescribed by Section 6511(d)(2)(A) relating to the three year statute of limitations, no refund can be allowed. The Revenue Ruling goes on to state "However, where an additional bad debt or loss on worthless securities is

determined for such loss year, the effect of which is to increase the net operating loss, Section 6511(d)(1) of the Code provides that a claim for refund may be filed with respect to such bad debt or loss on worthless securities within 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback." In Shepardizing Revenue Ruling 55-523, it does not appear that this ruling has been cited in any subsequent rulings or cases other than the Armstrong case. We believe that the rationale in Revenue Ruling 55-523 supports our taxpayers' position. Specifically, although our taxpayers did not discover an additional bad debt after they filed their 1973 return, our taxpayers did, over a period of several years, incur

significant adjustments to those deductions as shown in the statement of facts contained in Section I of this letter. Therefore, the amount and validity of the deductions taken in 1973 have always been and are still somewhat in doubt. It is this type of situation that we suggest Section 6511(d)(1) was designed to encompass. The taxpayer on the other hand, in both the Smith case and the Armstrong case, took bad-debt deductions which were not challenged by the Internal Revenue Service, while our taxpayers' bad-debt deductions have been under challenge by the Internal Revenue Service for a number of years.

Based upon the above analysis and factual distinctions between our taxpayers' case and both the Smith case and the Armstrong case, we suggest that

not only does the Smith case support our main position on the seven year statute of limitations, but also the Armstrong case is in our favor when you consider the facts in our case that are distinguishable from the facts in the Armstrong case.

* * *

If you have any questions with regard to the above presentation which you requested, please do not hesitate to call. Further, I would be most happy to see your thoughts or the thoughts of the District Counsel on this issue, because we have assumed, since being advised in June, 1979 that the Internal Revenue Service was in agreement, that the claims for refund in issue were timely filed, and we have devoted our entire attention to the merits of the numerous issues raised by

the revenue agent's examination including the several bad-debt issues covered in our protest.

Sincerely,

Robert E. Johnson

REJ:cp
Enclosures
cc: Mr. Charles E. Husman
Mr. William L. Robertson

APPENDIX V

UNITED STATES DISTRICT COURT
FOR THE
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

INDIANA NATIONAL CORPORATION AND ITS SUBSIDIARIES: INDIANA NATIONAL BANK, INDIANA REALTY, INC., INDIANA NATIONAL NETWORK CORP., INDIANA MORTGAGE CORP., CONSUMER MARKETING SERVICES, INC., TOWER AGENCY, INC., INDIANA NATIONAL OVERSEAS CORP., TFAC, INDIANA NATIONAL LEASING, INC. AND CITADEL FINANCE, INC.	)	
Plaintiffs,	)	
v.	)	CIVIL ACTION NO. IP88-277C
UNITED STATES OF AMERICA,	)	
Defendant.	)	

AFFIDAVIT OF CHARLES E. HUSMAN

Charles E. Husman, being duly sworn, deposes and says as follows:

1. He is the Vice President and Tax Manager of the Indiana National

Corporation ans as such is familiar with the U. S. Corporation Income Tax Returns and related documents filed with the Internal Revenue Service ("Service") by Indiana National Corporation and its Subsidiaries for the calendar year 1967 and subsequent years, as well as the Complaint of Indiana National Cororation and its Subsidiaries ("plaintiffs") filed on March 9, 1988 against the United Staes of America ("defendant") in the United States District Court for the Southern District of Indiana, Indianapolis Division, Civil Action No. IP 88-277C ("Complaint").

2. The Complaint seeks refunds of federal income taxes paid by the plaintiffs for the calendar years 1973, 1970 and 1967. During these years, plaintiffs utilized the reserve method

for determining their annual bad debt deductions.

3. The claims for refund filed by plaintiffs for 1970 and 1967 are based upon a net operating loss ("NOL") for 1973, which in turn is based on a significant bad debt deduction for the plaintiffs' taxable year 1973.

4. On August 12, 1988, defendant filed a Motion for Partial Dismissal and Memorandum of Law in Support of Motion for Partial Dismissal ("Memorandum") and on page 8 of its Memorandum accused plaintiffs of refusing to sign an extension of the statute of limitations fo assessment of tax with respect to the tax year 1973 and thereby inferred plaintiffs were dilatory and uncooperative with the Service.

5. Defendant's accusation is

incorrect; plaintiffs did execute the extension on or about October 25, 1977 and delivered it to the Service, although the plaintiffs believed the general three-year statute of limitations sought to be imposed on plaintiffs by the Service had expired.

6. On or about October 18, 1977, the agent in charge of the examination by the Service, David Laird, gave me a Form 872 requesting an extension of the statute of limitations for the tax year 1973.

7. On October 18, 1977, by letter dated October 18, 1977, I sought the advice of plaintiffs' certified public accounting firm of Ernst & Ernst (now Ernst & Whinney) and L. M. Ponder, attorney with the law firm of Barnes, Hickam, Pantzer & Boyd. A copy of my October 18, 1977 letter together with

enclosures is attached hereto as Exhibit 1.

8. Plaintiffs filed their 1973 Form 1120 corporate income tax return on September 16, 1974 (September 15, 1974 was Sunday), but the Service did not enter it into their system until January 20, 1975.

9. Attorney Ponder advised me by letter dated October 20, 1977 to have the plaintiffs sign the Form 872 with certain protective language. A copy of attorney Ponder's letter dated October 20, 1977 is attached hereto as Exhibit 2.

10. On or about October 25, 1977, I gave Revenue Agent David Laird the Form 872 with the recommended protective language. A copy of such Form 872 for 1973 signed by Frank J. Hurly, in his capacity as Treasurer of

Indiana National Corporation on October 24, 1977 in behalf of plaintiffs is attached hereto as Exhibit 3.

11. Although defendant states the "facts" in its page 8 accusation "are provided for background purposes only, and we have not obtained an affidavit from appropriate IRS personnel," I believe that, had David Laird and the other Service personnel been contacted, they would not have stated plaintiffs refused to execute an extension with respect to plaintiffs' 1973 tax year and would have stated, based on the facts presented in this Affidavit and attached exhibits, that plaintiffs were not dilatory or uncooperative with the Service during the Service examination of plaintiffs' tax returns for the years 1967 to 1978, inclusive, even though plaintiffs exercised their

administrative appeal rights by filing the formal protests and other documents discussed below in this affidavit.

12. Plaintiffs are affiliated corporations which filed consolidated Form 1120 income tax returns with the Service on the basis of a calendar year and their principal places of business are at One Indiana Square, Indianapolis, Indiana 46266 with principal business activities as follows:

Names of Plaintiffs	Principal Business Activity
Indiana National Corporation	Holding Company
Indiana National Bank (formerly The Indiana National Bank of Indianapolis)	Banking
Indiana Realty, Inc.	Real Estate
Indiana National Network Corp. (formerly INB International Inc.)	Electronic Funds Transfer Services (formerly Customs Brokerage)

Names of Plaintiffs	Principal Business Activity
Indiana Mortgage Corp	Mortgage Services
Consumer Marketing Services, Inc.	Marketing Services
Tower Agency, Inc.	Insurance Agency
Indiana National Overseas Corp.	Holding Corp., Foreign Bank Stock
TFAC (formerly, Tower Finance & Accept. Corp.)	Consumer Installment Loans
Indiana National Leasing, Inc.	Leasing
Citadel Finance, Inc.	Direct Consumer Financing

13. The Indiana National Bank of Indianapolis timely filed its Form 1120 corporate income tax return for 1967 with the Internal Revenue Service, and plaintiffs timely filed their Form 1120 corporate income tax returns for 1970 and 1973 with the Internal Revenue Service, and paid the taxes shown thereon in the respective amounts of $2,658,232.36, $1,983,052 and $195,154. Copies of these returns,

Forms 1120 for 1967 and 1970 and the first two pages of the Form 1120 for 1973, are attached hereto as Exhibits 4, 5 and 6.

14. On June 11, 1971, the District Director of Internal Revenue Service, Indianapolis, Indiana, sent Indiana National Bank of Indianapolis a 30-day letter containing income tax examination changes for 1966, 1967 and 1968 proposed by a revenue agent which were agreed to as follows:

Taxable income reported on return			$6,314,771.53
Plus: Additional income and unallowable deductions:			
(a)	Bad debts	$56,690.61	
(b)	Software expense	12,000.00	
(c)	Amortization of mortgage service contracts	697.64	

(d)	Miscellaneous	30,000.00	
(e)	Depreciation--Jefferson National Bldg.	6,238.77	
(f)	Proceeds from insurance	7,256.81	
			112,883.83
Subtotal			$6,427,655.36
Less: Nontaxable income and additional deductions:			
(g)	Amortization of software	2,000.00	
(h)	Depreciation	1,028.80	(3,028.80)
Corrected Taxable Income			$6,424,626.56

A copy of this 30-day letter is attached hereto as Exhibit 7, and a copy of the June 11, 1971 statement of tax due on the 1967 return sent to The Indiana National Bank of Indianapolis as a result of its agreement to the

30-day letter is attached hereto as Exhibit 8.

15. As a result of the above adjustments, The Indiana National Bank of Indianapolis paid to the Internal Revenue Service on June 16, 1971 additional Federal income tax for 1967 in the amount of $52,730.41 together with interest in the amount of $9,431.22, or a total payment of $62,161.63. A copy of the check dated June 16, 1971 by which such payment was made is attached hereto as Exhibit 9.

16. On or about March 6, 1974, the plaintiffs filed with the Service Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, and made payment on March 5, 1974 to the Internal Revenue Service of $125,000 with respect to the calendar year 1973. A copy of the

plaintiffs' Form 7004 is attached hereto as Exhibit 10, and a copy of the deposit slip evidencing payment of this $125,000 amount is attached hereto as Exhibit 11.

17. On or about May 30, 1974, the plaintiffs filed with the Service Form 7005, Application for Additional Extension of Time to File Corporation Income Tax Return, and made payment on June 14, 1974 of $125,000 with respect to the calendar year 1973. A copy of the plaintiffs' Form 7005 is attached hereto as Exhibit 12, and a copy of the deposit stub evidencing payment of this $125,000 is attached hereto as Exhibit 13.

18. The Form 7005 was returned to the plaintiffs with an endorsement dated June 6, 1974 from the Service granting the additional extension to

September 15, 1974, and the original Form 7005 was stamped "received" by the Memphis Service Center on June 3, 1974. A copy of the endorsement granting the extension appears on the previously attached Exhibit 12.

19. September 15, 1974, was a Sunday, and on September 16, 1974, the plaintiffs filed with the District Director of Internal Revenue Service, Indianapolis, Indiana, their Form 1120, U. S. Corporation Income Tax Return, claiming a refund of corporate income taxes of $54,879, having previously paid $250,033 in corporate income taxes, as shown on the previously attached Exhibit 6.

20. Plaintiffs' 1973 federal income tax return claimed total bad debt deductions originally of $6,038,574 as follows:

Indiana National Bank	$5,894,396
Indiana Mortgage Corp.	$103,294
Consumer Marketing Service, Inc.	$35,000
TFAC, Inc.	$2,718
Citadel Finance, Inc.	$3,167

21. Plaintiffs' 1973 return reported a net operating loss for the calendar year 1973 of $4,125,569, so that, absent the bad-debt deductions claimed, there would have been no net operating loss for 1973.

22. On September 16, 1974, the plaintiffs filed a Form 1120X, for the calendar year 1970, changing the foreign tax credit election to a per country basis, and the Form 1120X indicates that no tax liability was calculated on the Form 1120X "as the effect of this election will be included in the offset of the net operating loss carryback from the 1973 return." A copy of plaintiffs' Form

1120X for 1970 is attached hereto as Exhibit 14.

23. On December 31, 1974, the plaintiffs filed with the District Director of Internal Revenue Service, Indianapolis, Indiana, a Form 1120X amended return for the calendar year 1973 amending, among other things, the following items:

(a) The bad debt deduction was reduced by the amount of $162,218 "to agree with 1972 RAR (in progress)".

(i) One adjustment was attributable to reduction in the eligible loans outstanding of The Indiana National Bank at the end of the calendar year 1972 from $768,062,650 to $742,061,324. In addition, the experience ratio was amended from .3456% to .34999032715%. This resulted in a

decrease in the 1973 bad debt deduction of The Indiana National Bank of $137,873.

(ii) The "reserve balance" for the Indiana Mortgage Corporation was "adjusted to agree with 1972 RAR (in progress)" from $183,280 to $121,647 resulting in a decrease in the subsidiary's 1973 bad debt deduction of $24,345.

(b) Additional adjustments were made on the Form 1120X for the calendar year 1973 with respect to:

(i) Amortization;

(ii) Depreciation;

(iii) Interest expense; and

(iv) Corrected schedule of partnership ordinary gains/losses.

A copy of plaintiffs' Form 1120X for 1973 is attached hereto as Exhibit 15.

24. On December 31, 1974, a Form 1139 was filed for the calendar year 1973 by the plaintiffs with the District Director of Internal Revenue Service, Indianapolis, Indiana, claiming refunds for the calendar years 1970 and 1971 in the respective amounts of $976,764 and $89,819, said refunds being attributable to a net operating loss carryback from 1973 of $4,635,548 and an unused investment credit of $193,202. A copy of plaintiffs' Form 1139 for 1973 is attached hereto as Exhibit 16.

25. The net operating loss figure, on the plaintiffs' Form 1139 reflected an increase from the original net operating loss for 1973 of $509,979, and this increase was attributable to the Form 1120X filed December 31, 1974 for the calendar year

1973 and the decrease in bad-debt deductions and increases in other deductions referred to in paragraph 12 above.

26. On December 31, 1974, the plaintiffs' Form 1139 carrying back the unused investment credit of $971,297 from the calendar year 1970 to the calendar year 1967 was filed with the District Director of Internal Revenue Service, Indianapolis, Indiana. A copy of plaintiffs' Form 1139 for 1970 is attached hereto as Exhibit 17.

27. On January 7, 1975, the plaintiffs filed with the District Director of Internal Revenue Service, Indianapolis, Indiana, a Form 1120X amended return for the calendar year 1973 claiming a refund of $8,780, and this amended return was filed because the Form 1120X filed December 31, 1974,

was incomplete and contained a typographical error. A copy of plaintiffs' Form 1120X for 1973 is attached hereto as Exhibit 18.

28. The Indiana National Bank and the Service, through their authorized representatives, on the respective dates November 4, 1975 and November 5, 1975 executed a Form 872-B, Consent Fixing Period of Limitations Upon Assessment of Miscellaneous Excise Taxes, for the period January 1, 1972 through December 31, 1973 and extending the statutory period of limitations to December 31, 1977. A copy of such Form 872-B is attached hereto as Exhibit 19.

29. On June 1, 1976, the plaintiffs filed with the District Director of Internal Revenue Service, Indianapolis, Indiana, a Form 1120X amended return for the calendar year

1970 eliminating the foreign tax credit ("FTC") carryback from 1972 due to plaintiffs' amended 1972 return filed with the Service on December 2, 1975, and increasing the usability of investment tax credit carryback from 1972 due to decrease in FTC allowable. A copy of plaintiffs' Form 1120X for 1970 is attached hereto as Exhbiit 20.

30. On September 15, 1977, the plaintiffs filed a Form 1120X for 1973 with the District Director of Internal Revenue Service, Indianapolis, Indiana, claiming a net operating loss in the amount of $4,098,674 and a refund of corporate income tax of $17,662 for 1973. A copy of the plaintiffs' 1973 Form 1120X amended return and claim for refund of corporate income tax of $17,662 was attached to the Complaint as Exhibit A.

31. On September 15, 1977, the plaintiffs filed a Form 1120X amended return for 1970 with the District Director of Internal Revenue Service, Indianapolis, Indiana, carrying back the net operating loss from 1973 per the Form 1120X filed September 15, 1977, in the amount of $4,098,674, thus reducing the plaintiffs' tax for 1970 from $1,108,872 to $100,598, thereby generating the claim for refund of $1,008,274. A copy of the plaintiffs' 1970 Form 1120X amended return and claim for refund of corporate income tax of $1,008,274 was attached to the Complaint as Exhibit B.

32. On September 15, 1977, the plaintiffs filed a Form 1120X amended return for 1967 with the District Director of Internal Revenue Service, Indianapolis, Indiana, showing a

recomputation of the tax to reflect an investment tax credit carryback from 1970 to 1967 as a result of the $4,088,674 net operating loss carryback from 1973 to 1970. A copy of the plaintiffs' 1967 Form 1120X amended return and claim for refund of corporate income tax of $862,466 was attached to the Complaint as Exhibit C.

33. On July 18, 1979, the District Director of Internal Revenue Service, Indianapolis, Indiana, sent the plaintiffs a 30-day letter containing the income tax examination changes proposed by revenue agent David E. Laird in his Form 4549-A dated October 18, 1978 covering the calendar years of the plaintiffs 1967, 1970, 1973 and 1974. This letter proposed overpayments for 1967, 1970 and 1973 in the respective amounts of $671,761,

$802,344 and $20,918, and a deficiency for 1974 in the amount of $92,863. Among the adjustments proposed in the revenue agent's report were adjustments to bad-debt deductions relating to the subsidiary, The Indiana National Bank, in the amount of $135,464 for 1973 and an additional bad-debt deduction of $10,216 for 1974, adjustments constituting reductions to bad-debt deductions relating to the subsidiary Indiana Mortgage Corporation for 1973 and 1974 in the respective amounts of $103,294 and $35,945 and adjustments constituting reductions to bad-debt deductions relating to the subsidiary TFAC, Inc. for 1974 in the amount of $122,183. A copy of such 30-day letter is attached hereto as Exhibit 21.

34. On November 16, 1979, the plaintiffs filed a protest to the July

18, 1979 30-day letter of the District Director. Among other items, the protest placed in issue the adjustments with regard to bad debts of Indiana Mortgage Corporation for 1973 and 1974 in the respective amounts of $103,294 and $35,945 and TFAC, Inc. for 1974 in the amount of $122,183. A copy of plaintiffs' protest is attached hereto as Exhibit 22.

35. Following the filing of plaintiffs' protest, numerous conferences with the Internal Revenue Service Appeals Division were held. On August 10, 1983, plaintiffs' counsel, at the request of the Service filed with the Service a supplemental letter setting forth plaintiffs' position on a statute of limitations question raised by the Service in 1983. A copy of the plaintiffs' Augsut 10, 1983 letter was

attached to the Complaint as Exhibit D.

36. The Service has negotiated a settlement with the plaintiffs with respect to the issues raised in plaintiffs' protests for 1973 and 1974 other years 1975, 1976, 1977 and 1978 which, among other adjustments, included a reduction to the bad-debt deduction of The Indiana National Bank of $135,464 for 1973 and increases in its bad-debt deductions for 1974, 1975 and 1976 in the respective amounts of $10,216, $5,406,972 and $4,711,196; reduction to the bad-debt deduction of Indiana Mortgage Corporation of $120,058 for 1976; reductions in the bad debt . deductions of Indiana Acceptance, Inc., for 1975 and 1976 in the respective amounts of $34,243 and $23,992; and a reduction in the bad debt deduction of INB Mortgage Holding,

Inc. for 1976 of $64,387. This settlement is reflected in a Form 906, Closing Agreement on Final Determination Covering Specific Items, signed by authorized representatives of plaintiffs on April 1, 1987 and the Service on February 25, 1987. The amounts of refund of corporate income tax plus interest for 1977 and deficiency in corporate income tax plus interest for 1978 were not corrected by the Internal Revenue Service Center until 1988. A copy of the Form 906 was attached to the Complaint as Exhibit E.

/s/ Charles E. Husman
Charles E. Husman

Subscribed and sworn to before me, a Notary Public in and for Marion County and State of Indiana, this 28th day of September, 1988.

(SEAL) /s/ Carole Ann Blankenship
Notary Public

Printed

My Commission Expires:
August 27, 1991

County of Residence:
Marion County

REJ:2533:cp

APPENDIX VI

No. 474-69

IN THE UNITED STATES COURT OF CLAIMS

SMITH ELECTRIC COMPANY, INC.,

Plaintiff

v.

THE UNITED STATES OF AMERICA,

Defendant

BRIEF FOR THE UNITED STATES

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IN THE UNITED STATES COURT OF CLAIMS

No. 474-69

SMITH ELECTRIC COMPANY, INC.,

Plaintiff

v.

THE UNITED STATES OF AMERICA,

Defendant

BRIEF FOR THE UNITED STATES

This suit is brought by the taxpayer to recover federal income taxes for the years 1957 and 1958 in the respective amounts of $5,738.01 and $10,960.19, plus interest as provided by law.

QUESTION PRESENTED

Whether the special seven-year statute of limitations with respect to the deductibility of worthless debts

from gross income, provided by Section 6511(d)(1) of the Internal Revenue Code of 1954, is available to a taxpayer for the purpose of deducting an addition to a reserve for bad debts.

STATUTES AND REGULATIONS INVOLVED

The statutes and Regulations involved are set forth in Appendix A, infra.

STATEMENT

The pertinent facts of this case have been stipulated by the parties under Rule 134(b). The stipulation reads as follows:

1. This suit involves the refund of Federal income taxes for the years 1957 and 1958 in the respective amounts of $5,738.01 and $10,960.19, plus interest.

2. Plaintiff, Smith Electric Company, hereinafter called "Smith Electric", is a New York corporation with its principal place of business at 110 Remsen Street, Cohoes, New York. The corporation is engaged primarily in wholesale electrical distributing and contracting.

3. Commencing in 1957, Smith Electric advanced substantial sums to Cohoes Screen Printing, hereinafter called "Cohoes." Notes were issued for the loans involved, and interest income accrued for the years involved was reported as taxable income. By 1959, Cohoes owed Smith Electric $80,050.

4. In 1960, it became evidence that Cohoes was insolvent.

5. A contracted sale of the assets of Cohoes to an outside party was executed on Mary 19, 1960, and a

notice to creditors, pursuant to the Bulk Sales Law of New York State, was sent on May 25, 1960, with the closing to take place on June 6, 1960.

6. On June 3, 1960, a creditor, The King Service, Inc., commenced an action in the New York State Supreme Court against Cohoes and obtained an injunction against the transfer of any of its assets.

7. Smith Electric anxious to avoid the filing of a petition in bankruptcy against Cohoes since it felt this would be injurious to its name in the Capital District area of New York State (Albany, Troy, Cohoes and Schenectady), from which area the bulk of its business was derived, negotiated, through its president, with the King Service, Inc., and arranged to have the action withdrawn on condition,

inter alia, that the taxpayer forego its respective pro rata share of the proceeds of sale.

8. Cohoes realized $15,000 on the sale of its assets in June, 1960; no part of this amount was received by the taxpayer.

9. Smith Electric employed the accrual method of accounting for computing taxable income and had established the reserve method of treating bad debts. Under the latter method, a deduction from gross income is allowed for a reasonable addition to the reserve for bad debts.

10. On its federal income tax return for calendar year 1960, Smith Electric added $81,943.79 to its reserve for bad debts. Included in this deduction was provision for worthlessness of $80,050 of notes

receivable from Cohoes. The procedure that Smith Electric used in determining a reasonable addition to bad debts consisted to taking a percentage, historically derived from previous experience, of outstanding trade accounts receivable at the end of each year as being the amount necessary for the reserve for bad debts. If the reserve balance as of the beginning of the year less the debts charged against the reserve during the year was smaller than the calculated figure, the resulting difference was the amount added to the reserve. The historical percentage was not applied against the receivables other than trade accounts. For 1960, the reserve balance at the beginning of the year was $4,678.02. There were recoveries of bad debts during the year of $201.72 and accounts

charged against the reserve during the year amounted to $82,288.69 (inclusive of the receivable from Cohoes). The reserve balance necessary at the end of 1960 was computed by applying a percentage of 2.432608506 times the trade accounts receivable balance of $186,418.67 which resulted in a product of $4,534.84. Thus, the addition to the reserve was $81,943.79. This created a net operating loss of $51,034.85 for 1960. This loss was carried back to 1957 to offset the net income in that year of $19,1?6.69 and to 1958 to offset the net income in that year of $31,683.35. These offsets created the present claims for refund in 1957 and 1958 in the amounts, respectively, of $5,738.01 and $10,960.19, which was the entire tax paid for each of those two years.

11. On March 11, 1966, taxpayer filed claims for refund for the taxable years 1957 and 1958 arising out of a net operating loss in 1960 due to bad debt losses.

12. The Commissioner disallowed these claims for refund on November 15, 1967, on the ground that they were not filed within the period of limitations set forth in Section 6511 of the Internal Revenue Code of 1954.

13. Plaintiff's petition was filed in this Court on November 10, 1969.

ARGUMENT

THE SPECIAL SEVEN-YEAR STATUTE OF LIMITATIONS WITH RESPECT TO THE DEDUCTION OF WORTHLESS DEBTS, PROVIDED BY SECTION 6511(d)(1) OF THE INTERNAL REVENUE CODE OF 1954, IS INAPPLICABLE TO THE DEDUCTION OF AN ADDITION TO A RESERVE FOR BAD DEBTS

A. While a taxpayer under the specific charge-off method to obtain a deduction from gross

> income must determine the year in which a specific bad debt becomes worthless, a taxpayer under the reserve method can obtain a deduction for an estimated addition to its reserve for bad debts, which is generally ascertained by reliance upon past experience with its accounts as a composite.

The issue in the case at bar squarely presents the problem of whether or not the seven-year period of limitations with respect to worthless debts provided by Section 6511(d)(1) of the Internal Revenue Code of 1954,[1/] Appendix A, infra, is inapplicable to a taxpayer who rather than charging off worthless debts, as they occur, uses the reserve method of accounting for bad debts whereby he deducts only such

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1/All statutory references are to the Internal Revenue Code of 1954, unless otherwise stated.

additions to the reserve as are necessary to increase it to an amount sufficient to absorb such losses. The resolution of this issue requires an understanding of the historical development of the above-cited two methods of accounting for bad debts and the differences between them as derived from the applicable statutes, Treasury Regulations, legislative history, and case law.

Presently, Section 166 authorizes two mutually exclusive methods of accounting for bad debts; the direct charge-off method and the reserve method of treating bad debts. See Ehlen v. United States, 163 Ct. Cl. 35, 323 F.2d 535 (1963); Atlantic Bank & Trust Co. v. Commissioner, 59 F.2d 363 (C.A. 4, 1932). Under Section 166(a), Appendix A, infra, a taxpayer using the

specific charge-off method is allowed as a deduction from gross income the amount of any debt which becomes wholly worthless within the taxable year (Section 166(a)(1)) and any debt which becomes partially worthless within the taxable year to the extent of the part charged-off within such year as a deduction (Sec. 166(a)(2)). In contrast, under Section 166(c), Appendix A, infra, a taxpayer using the reserve method of accounting for bad debts is allowed as a deduction from gross income a reasonable addition to its reserve for bad debts.

In the beginning only the use of the direct charge-off method of accounting for bad debts enabled a taxpayer to obtain a deduction from gross income. A deduction was allowed for "debts due to the taxpayer actually

ascertained to be worthless and charged off within the year." Income Tax Act of 1913, c. 16, 38 Stat. 114, 166 (Sec. IIB); Revenue Act of 1916, c. 463, 39 Stat. 756 (Sec. 5(a)). The word "actually" was eliminated from the requirement "actually ascertained" in the Revenue Act of 1918, c. 18, 40 Stat. 1057 (Sec. 214(a)(7)), and a deduction for partially worthless debts was first permitted in the Revenue Act of 1921, c. 136, 42 Stat. 227 (Sec. 214(a)(7)), and later modified by the Revenue Act of 1932, c. 209, 47 Stat. 169 (Sec. 23(j)); the Revenue Act of 1942, c. 619, 56 Stat. 798 (Sec. 124(a)); and the Revenue Act of 1943, c. 63, 58 Stat. 21 (Sec. 113).

Prior to the enactment of the Revenue Act of 1942, a taxpayer under the direct charge-off method of

accounting for bad debts to obtain a deduction from gross income had to comply with both the requirements that he ascertain a debt to be worthless and that he charge it off on his books. Minneapolis, St. Paul Railroad Co. v. United States, 164 Ct. Cl. 226, 239-240 (1964); Fairbanks, Morse & Co. v. Harrison, 63 F. Supp. 495, 501 (N.D. Ill., 1945.) The Revenue Act of 1942, supra, Section 124(a)2/ substituted the objective test of actual worthlessness within the taxable year for the preceding two requirements with the following language: "debts which

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2/ The predecessor section to Code Section 166(a) was enacted as Section 23(k)(1) of the Internal Revenue Code of 1939 (Appendix B, infra), and added by the Revenue Act of 1942, supra, Section 124(a).

become worthless within the taxable year."

Under the present objective test of actual worthlessness, a taxpayer under the specific charge-off method has the burden of proof to show the fact of worthlessness within the taxable year. If the debt did not in fact become worthless within such year but prior or subsequent thereto, no deduction is allowed. Minneapolis, St. Paul Railroad Co. v. United States, supra; Redman v. Commissioner, 155 F.2d 319 (C.A. 1, 1946); Estate of Fahnestock v. Commissioner, 2 T.C. 756 (1943). Accordingly, the determination of the worthlessness of a debt within the taxable year calls for a penetrating inquiry by the courts. Minneapolis, St. Paul Railroad Co., et

al. v. United States, supra, pp. 239-241.

The reserve method of accounting for bad debts was first authorized in the Revenue Act of 1921, supra, Section 214(a)(7), as an alternative to the precision required of a taxpayer under the specific charge-off method of accounting for bad debts. (H. Rep. No. 350, 67th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2), 168, 177). It provided for a deduction from gross income for a reasonable addition to a reserve for bad debts, and it has remained essentially unchanged in the present Code (Section 166(c)).3/

3/ The reserve method of accounting for bad debts was contained in Section 23(k)(1) of the Internal Revenue Code of 1939; this Section also authorized use of the specific charge-off method.

Under the reserve method, deductions are available only for reasonable additions to the reserve and not for specific worthless debts charged against the reserve. Rogan v. Commercial Discount Co., 149 F.2d 585 (C.A. 9, 1962). The Tax Court in R. Gsell & Co. v. Commissioner, 34 T.C. 41, 56 (1960), rev'd on another issue, 294 F.2d 321 (C.A. 2, 1961), explained the function of a bad debt reserve and the addition thereto in the following language:

> Essentially, a bad debt reserve constitutes an estimate of those losses which can reasonably be expected to result from current business debts. In every case, then, the ultimate question is not whether the proposed addition to the reserve is sufficient to absorb the estimated losses, but

> rather the credit balance in the reserve is adequate for that purpose. * * * While the reasonableness of an addition to the reserve ordinarily will be judged in the light of the taxpayer's experience in collecting its accounts, no hard and fast standard should be adopted. A formula which may have produced a reasonable addition over a series of years might very well prove inadequate under the circumstances attendant upon the year involved. * * * In the final analysis, the estimate as to the reserve required for any addition will be measured in light of the conditions which exist at the time the estimate is made. Primarily, the reasonableness of any addition will depend on the total amount of debts outstanding at the close of the year, including current debts as well as those which arose in prior years, and the total amount of the existing reserve. Regs. 118, sec. 39.23(k)-5.

Cf., Citizens Federal S. & L. Assn. of Cleveland v. United States, 154 Ct. Cl. 305, 313, 290 F. 2d 932, 937 (1961).

In short, unlike a taxpayer using the specific charge-off method who must determine at his peril the year in

which a bad debt becomes worthless, a taxpayer under the reserve method can support his addition to a reserve by generally relying on past experience with accounts as a composite as in the case at bar and also by using known factors relating to specific accounts when such information is available; and he may make adjustments in later years to reflect the inadequacy or excessiveness of the reserve up to that point. Citizens Federal S. & L. Assn. of Cleveland v. United States, supra; Ehlen v. United States, supra; North Carolina National Bank v. United States, 170 Ct. Cl. 765, 345 F. 2d 544 (1965); Calavo v. Commissioner, 304 F. 2d 650, 654 (C.A. 9, 1962).

When a taxpayer under the specific charge-off method erroneously fails to claim a deduction in the proper taxable

year in which a specific bad debt becomes worthless, he may file a claim for refund for such year and, in recognition of the difficulty in pinpointing the year of worthlessness, is given a special seven-year period of limitation within which to do so. (Sec. 6511(d)(1).) In contrast, pursuant to Treasury Regulations on Income Tax (1954 Code), Sec. 1.166-4(b)(2), Appendix A, infra[4/], when a taxpayer under the reserve method fails to claim a deduction for an adequate addition to its reserve in the taxable year in which one or more

---

4/ This regulation was originally promulgated in 1936 as Treasury Regulations 94 (Art. 23 (k)-5), and it was subsequently carried over as Treasury Regulations 118, Section 39.23(k)-5, Appendix B, infra.

debts unexpectedly becomes worthless, there is no equivalent need for an enlarged period for filing a claim for refund to retroactively enlarge its addition for that year. In such a case, the remedy of the taxpayer is to increase the addition to the reserve in the taxable year in which he discovers the inadequacy of his estimate. Wengel, Inc. v. United States, 306 F. Supp. 121 (E.D. Mich., 1969); Farmville Oil & Fertilizer Co. v. Commissioner, 78 F. 2d 83 (C.A. 4, 1935); Consolidated Dry Goods Co. v. United States, 35 F. 2d 523 (Mass., 1940).

Similarly, in accordance with Treasury Regulations Section 1.166-4(b)(2), when a taxpayer's subsequent collection upon existing debts is greater than anticipated at the time of the creation of the

existing reserve, it need not include the excess in its income but need only utilize the excess to reduce what otherwise might have been a reasonable addition to its reserve in the current taxable year. Ehlen v. United States, supra; R. Gsell & Co. v. Commissioner, supra. A taxpayer under the direct charge-off method of accounting for bad debts, however, upon recovering bad debts in subsequent years may exclude the amount recovered from its gross income only to the extent that the worthless debt did not in any prior year reduce its income tax liability (Sec. 111 of the Code, Appendix A, infra).5/

5/ The predecessor Section to Code Section 111 was enacted as Section 22(b)(12) of the Internal Revenue Code of 1939 (Appendix F, infra) and was added by the Revenue Act of 1942, supra, Section 116(a).

B. The plain language of Section 6511(d)(1) and its legislative history show that it is inapplicable to taxpayers using the reserve method of accounting for bad debts

In the instant suit, the taxpayer, on March 11, 1966, filed claims for refund for 1956 and 1958 arising from a net operating loss carry-back in 1960, which was caused by an addition of $81,943.79 to its bad debt reserve in that year. Under Section 6511(d)(2)(A) of the Code, Appendix A, infra, claims for refund of an alleged overpayment in tax attributable to a net operating loss carry-back must be filed within the period which terminates with the 15th day of the 39th month following

the end of the corporation's taxable year which resulted in the net operating loss carry-back (here March 15, 1964). Consequently, unless the taxpayer is entitled to use the seven-year period of limitation with respect to bad debts provided in Section 6511(d)(1), its claims for refund are barred under Section 6511(d)(2)(A).6/

The predecessor to Code Section 6511(d)(1) was enacted as Section 322(b)(5) of the Internal Revenue Code

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6/ A claim for refund of an overpayment in tax must be filed within 3 years from the time the return was filed or within 2 years from the time the tax was paid. (Sec. 6511(a) of the Code, Appendix A, infra.) Section 6511(d)(2)(A), however, provides a special period of limitation with respect to net operating loss carry-backs.

of 1939, Appendix B, infra, and was added by the Revenue Act of 1942, supra, Section 169(a), and amended by Section 5(a) of the Tax Adjustment Act of 1945, c. 340, 59 Stat. 517.7/ Section 6511(d)(1) of the Code provides in pertinent part as follows:

> (d) Special Rules Applicable to Income Taxes.
>
> (1) Seven-year period of limitation with respect to bad debts and worthless securities.-- If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of--
>
> (A) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section

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7/ The predecessor to Code Section 6511(d)(2)(A) was enacted as Section 322(b)(6) of the Internal Revenue Code of 1939, Appendix B, infra, and was added by Section 5(b) of the Tax Adjustment Act of 1945, supra.

> 165(g), of a loss from worthlessness of a security, or
>
> (B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover,
>
> in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later. * * * (Underlining in text added for emphasis.)

* * *

The special period of limitations provided by Section 6511(d)(1) is by

its own underlined language clearly applicable only to taxpayers who use the specific charge-off method and not to those who elect to use the reserve method of accounting for bad debts. Similarly, Section 322(b)(5) of the 1939 Code, the forerunner of Section 6511(d)(1), used the identical underscored language in referring to Section 23(k)(1) of the 1939 Code, the forerunner to Section 166(a) and (c). This plain language of Section 6511(d)(1) refers to the deductibility of debts which become worthless. Only taxpayers using the specific charge-off method can deduct from gross income debts which become worthless. Taxpayers using the reserve method of accounting for bad debts are entitled to a deduction from gross income for a

reasonable addition to their reserve for bad debts.

The legislative history of Section 6511(d)(1) reinforces the conclusion from the plain meaning of the statute that Congress did not intend that the seven-year statute of limitations be available to taxpayers using the reserve method. the purpose for the extended statute of limitations with respect to bad debt deductions is stated as follows in H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 44-45 (1942-2 Cum. Bull. 372, 408):

> 3. TREATMENT OF BAD DEBTS
>
> The bill makes substantial changes in the treatment of bad debts. These changes are designed to remove existing inequities and to improve the procedure through which bad-debt deductions are taken. It also makes certain the treatment which is to be accorded to the recovery of bad debts and previously paid taxes.

A. ELIMINATION OF CHARGE-OFF REQUIREMENTS.

In order to get a deduction for a bad debt under the present law two requirements must be met: (a) the debt must be ascertained to be worthless, and (b) it must be charged off during the taxable year.

These two requirements have caused considerable difficulty, particularly the requirement of a charge-off in cases where the taxpayer keeps inadequate records. In lieu of these two requirements, the bill substitutes the test of "debts which become worthless within the taxable year." Thus, whether or not the mechanics of the charge-off are fulfilled, the fact of worthlessness, which is the proper criterion, will prevail.

B. LONGER STATUTE OF LIMITATIONS FOR BAD DEBTS AND WORTHLESS STOCK LOSSES

Under the existing law, the taxpayer may be whipsawed out of a deduction for a bad debt because of the uncertainty as to the time at which the debt becomes worthless. Later evidence often discloses that present decisions as to the year in which a debt becomes worthless are erroneous. For example, the taxpayer concludes that a debt has become

> bad and takes the deduction in that year, only to discover by later evidence that the debt actually became worthless 3 years previously. The statute of limitations having run on such previous year, this deduction is lost forever to the taxpayer. Conversely, where the debt actually becomes worthless in a year later than the year chosen by the taxpayer, the 3-year statute of limitations may operate against the Government.
>
> To relieve this inequitable situation, the bill replaces the present 3-year statute of limitations in such cases with a 7-year statute, giving a considerably greater flexibility to the allowance of bad debt deductions in the proper year.

Additionally, in the hearing before the House Committee on Ways and Means which considered Section 322(b)(5) of the 1939 Code, the forerunner of Section 6511(d)(1), Randolph Paul, Tax Adviser to the Secretary of the Treasury, testified as follows with respect to the purpose of the seven-year period of limitations (1

House Hearing, Committee on Ways and Means, 77th Cong., 2d Sess., pp. 92-93).

(c) Statute of limitations on bad debts and worthless stock losses.--The difficulties surrounding the deduction for bad debts and worthless stock losses have long been familiar sources of irritation to taxpayers and the Commissioner alike. It is far from easy to ascertain when a debt is bad or when a share of stock becomes worthless. At the same time, the taxpayer must select the proper year before the statute of limitations has run with respect to that year.

Much litigation is occasioned by the artificial barrier thus thrown up by the statute of limitations, as a taxpayer who chose one year only to be met with the claim that an earlier but barred year was the correct year must battle to defend his choice or lose the deduction entirely.

It is believed that this useless litigation and many of the difficulties in this field can be avoided by, first, eliminating the ascertainment of worthlessness and the charge-off requirements in the case of bad debts--including securities producing capital losses--and, second, allowing a 7-year statute of limitations with respect to refund claims relating

to a deduction on account of these items.

The legislative history demonstrates that the longer seven-year period of limitations was desirable because a taxpayer under the specific charge-off method must identify and take a deduction for a bad debt in the year in which the debt becomes worthless. Such a taxpayer with further evidence may find that the debt became worthless in a year earlier than the one it selected, and the three-year statute of limitations could bar its claim for refund by the time it discovered the error. On the other hand, the three-year statute of limitations could also operate against the Government to bar an additional assessment where the debt became worthless in a year later than the year

chosen by the taxpayer. To eliminate these inequities, Congress believed that the extended seven-year statute of limitations would given "considerably greater flexibility to the allowance of bad debt deductions in the proper year."

The problem which Congress attempted to alleviate is inherent to taxpayers using the specific charge-off method but not to taxpayers using the reserve method of accounting for bad debts. A taxpayer using the specific charge-off method must determine at his peril the year in which the debt became worthless. If the debt did not become worthless in the year selected by the taxpayer, no deduction is allowed. A taxpayer under the reserve method, however, does not deduct specific bad debts and is only entitled to a deduction from gross income for an

estimated reasonable addition to its reserve for bad debts. As previously mentioned, the addition to the reserve account is generally supported by relying on past experience with accounts as a composite as in the instant suit and also by using known factors relating to specific accounts when such information is available and underestimation or overestimation is reflected in the additions to the reserve for subsequent years.

In sum, had taxpayer used the specific charge-off method and failed to deduct from its gross income the worthless $80,050 of notes receivable from the insolvent debtor in 1960, it properly could have filed a timely claim for refund for such year within the seven-year period of limitations provided by Section 6511(d)11).

However, since the taxpayer used the reserve method and not the charge-off method, it did not have seven years to file a claim for refund even if the inadequacy of the deduction from gross income was correctable at all under the particular facts.

CONCLUSION

For all of the reasons set forth in our brief, judgment should be entered for the Government, and taxpayer's petition should be dismissed with prejudice.

Respectfully submitted,

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OCTOBER, 1971

REJ:2534

APPENDIX VII

Portion of House of Representatives Report No. 2333, Seventy-seventh Congress, First Session, on the Revenue Bill of 1942, page 408 dealing with "Treatment of Bad Debts" and "Longer Statute of Limitations for Bad Debts and Worthless Stock Losses," Section 322 of Internal Revenue Code of 1939:

3. TREATMENT OF BAD DEBTS.

The bill makes substantial changes in the treatment of bad debts. These changes are designed to remove existing inequities and to improve the procedure through which bad-debt deductions are taken. It also makes certain the treatment which is to be accorded to the recovery of bad debts and previously paid taxes.

(A) ELIMINATION OF CHARGE-OFF REQUIREMENTS.

In order to get a deduction for a bad debt under the present law two requirements must be met: (a) the debt must be ascertained to be worthless, and (b) it must be charged off during the taxable year.

These two requirements have caused considerable difficulty, particularly the requirement of a charge-off in cases where the taxpayer keeps inadequate records. In lieu of these two requirements, the bill substitutes the test of "debts which became worthless within the taxable year." Thus, whether or not the mechanics of the charge-off are fulfilled, the fact of worthlessness, which is the proper criterion, will prevail.

(B) LONGER STATUTE OF LIMITATIONS FOR BAD DEBTS AND WORTHLESS STOCK LOSSES.

Under the existing law, the taxpayer may be whipsawed out of a deduction for a bad debt because of the uncertainty as to the time at which the debt becomes worthless. Later evidence often discloses that present decisions as to the year in which a debt becomes worthless are erroneous. For example, the taxpayer concludes that a debt has become bad and takes the deduction in that year, only to discover by later evidence that the debt actually became worthless three years previously. The statute of limitations having run on such previous year, this deduction is lost forever to the taxpayer. Conversely, where the debt actually became worthless in a year later than the year chosen by the taxpayer, the

3-year statute of limitations may operate against the Government.

To relieve this inequitable situation, the bill replaces the present 3-year statute of limitations in such cases with a 7-year statute, giving a considerably greater flexibility to the allowance of bad debt deductions in the proper year.

(C) Nonbusiness Bad Debts.

* * *

APPENDIX VIII

Section 6511(a) PERIOD OF LIMITATION ON FILING CLAIM.--Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid.

APPENDIX IX

Section 6511(b)(2) LIMIT ON AMOUNT OF CREDIT OR REFUND.--

(A) LIMIT WHERE CLAIM FILED WITHIN 3-YEAR PERIOD.--If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return. If the tax was required to be paid by means of a stamp, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

(B) LIMIT WHERE CLAIM NOT FILED WITHIN 3-YEAR PERIOD.--If the claim was

not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim.

(C) LIMIT IF NO CLAIM FILED.--If no claim was filed, the credit or refund shall not exceed the amount which would be allowable under subparagraph (A) or (B), as the case may be, if claim was filed on the date the credit or refund is allowed.

APPENDIX X

Section 6511(d) SPECIAL RULES APPLICABLE TO INCOME TAXES.--

(1) SEVEN-YEAR PERIOD OF LIMITATION WITH RESPECT TO BAD DEBTS AND WORTHLESS SECURITIES.--If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of--

(A) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section 165(g), of a loss from worthlessness of a security, or

(B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover,

in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later. In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the

period prescribed in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

APPENDIX XI

Section 6511(d) (2) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO NET OPERATING LOSS OR CAPITAL LOSS CARRYBACKS.--

(A) PERIOD OF LIMITATION.-- If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback or a capital loss carryback, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends 3 years after the time prescribed by law for filing the return (including extensions thereof) for the taxable year of the net operating loss or net capital loss which results in such carryback, or the period prescribed in subsection (c) in respect of such taxable

year, whichever expires later; except that with respect to an overpayment attributable to the creation of, or an increase in a net operating loss carryback as a result of the elimination of excessive profits by a renegotiation (as defined in section 1481(a)(1)(A)), the period shall not expire before the expiration of the 12th month following the month in which the agreement or order for the elimination of such excessive profits becomes final.

In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b)(2) or (c), whichever is applicable, to the

extent of the amount of the overpayment attributable to such carryback.

APPENDIX XII

Section 6511(d)(4) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO INVESTMENT CREDIT CARRYBACKS.--

(A) PERIOD OF LIMITATION.-- If the claim for credit or refund relates to an overpayment attributable to a credit carryback, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends 3 years after the time prescribed by law for filing the return (including extensions thereof) for the taxable year of the unused credit which results in such carryback (or, with respect to any portion of a credit carryback from a taxable year attributable to a net operating loss carryback, capital loss carryback, or other credit carryback from a subsequent taxable year, the

period shall be that period which ends 3 years after the time prescribed by law for filing the return, including extensions thereof, for such subsequent taxable year) or the period prescribed in subsection (c) in respect of such taxable year, whichever expires later. In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to such carryback.

(B) APPLICABLE RULES.--If the allowance of a credit or refund of an overpayment of tax attributable to a credit carryback is otherwise prevented by the operation of any law or rule of law other than section 7122,

relating to compromises, such credit or refund may be allowed or made, if claim therefor is filed within the period provided in subparagraph (A) of this paragraph. In the case of any such claim for credit or refund, the determination by any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall not be conclusive with respect to any credit, and the effect of such credit, to the extent that such credit is affected by a credit carryback which was not in issue in such proceeding.

APPENDIX XIII

Treasury Regulations §301.6511(d)-1 Overpayment of income tax on account of bad debts, worthless securities, etc.

(a) (1) If the claim for credit or refund relates to an overpayment of income tax on account of --

(i) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless or, under section 165(g), of a loss from the worthlessness of a security, or

(ii) The effect that the deductibility of a debt or loss described in subdivision (i) of this subparagraph has on the application to the taxpayer of a carryover, then in lieu of the 3-year period from the time the return was filed in which claim may be filed or credit or refund allowed, as prescribed in section 6511(a) or

(b), the period shall be 7 years from the date prescribed by law for filing the return (determined without regard to any extension of time for filing such return) for the taxable year for which the claim is made or the credit or refund allowed or made.

(2) If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of a debt or loss, described in subparagraph (1) of this paragraph, has on the application of the taxpayer of a net operating loss carryback provided in section 172(b), the period in which claim for credit or refund may be filed shall be whichever of the following two periods expires later:

(i) Seven years from the last date prescribed for filing the return

(determined without regard to any extension of time for filing such return) for the taxable year of the net operating loss which results in such carryback, or

(ii) The period which ends with the expiration of the period prescribed in section 6511(c)within which a claim for credit or refund may be filed with respect to the taxable year of the net operating loss which resulted in the carryback.

(3) In the case of a claim for credit or refund involving items described in this section, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in section 6511(b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of

items described in subparagraph (1) of this paragraph. If the claim involves an overpayment based not only on the deductibility of items described in subparagraph (1) of this paragraph but based also on other items, the credit or refund cannot exceed the sum of the following:

(i) The amount of the overpayment which is attributable to the deductibility of items described in subparagraph (1) of this paragraph, and

(ii) The balance of such overpayment up to a limit of the portion, if any, of the tax paid within the period provided in section 6511(b)(2) or (c), or within the period provided in any other applicable provision of law.

(4) If the claim involves an overpayment based not only on the

deductibility of items described in subparagraph (1) of this paragraph but based also on other items, and if the claim with respect to any items is barred by the expiration of any applicable period of limitation, the portion of the overpayment attributable to the items not so barred shall be determined by treating the allowance of such items as the first adjustment to be made in computing such overpayment.

Supreme Court, U.S.
FILED
APR 23 1993
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No. 92-1427

In the Supreme Court of the United States

OCTOBER TERM, 1992

INDIANA NATIONAL CORPORATION AND INDIANA NATIONAL BANK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the 7-year statute of limitations in Section 6511(d)(1) of the Internal Revenue Code for refund claims arising from the carryback of certain bad debt deductions or the 38 1/2-month statute of limititations in Section 6511(d)(2)(A) and (d)(4)(A) of the Code for refund claims attributable to net operating loss carrybacks applies to the refund claim for a net operating loss carryback in this case.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A24) is reported at 980 F.2d 1098. The opinion of the district court (Pet. App. A25-A66) is reported at 775 F. Supp. 281.

JURISDICTION

The judgment of the court of appeals was entered on November 30, 1992. The petition for a writ of certiorari was filed on February 26, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are members of an affiliated group of corporations. In September 1974, they filed a consolidated income tax return for 1973 which reported a net operating loss to which a bad debt deduction had contributed (Pet. App. A2-A3). In December 1974, petitioners filed an amended income tax return for 1973, in which they reduced the amount of the claimed bad debt deduction (*id.* at A3).[1] At the same time, they filed applications for tentative carryback adjustments and refunds, claiming a tentative refund of $976,764 for 1970 and of $971,297 for 1967 (*id.* at A3-A4).[2]

On September 15, 1977, petitioners filed amended income tax returns for 1967 and 1970 (the carryback years) claiming refunds for the overpayments that resulted in those years as a consequence of carrying back the net operating loss that petitioners incurred in 1973 (the loss year). Petitioners claimed a $1,008,274 refund for 1970 based upon the carryback to 1970 of the net operating loss reported in petitioners' amended return for 1973 (Pet. App. A4, A31). They claimed an overpayment of $862,466 for 1967 based upon the carryback from 1970 to 1967 of an investment tax credit that was freed up by the carryback to 1970 of the 1973 net operating loss (*ibid.*).

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[1] Although petitioners ultimately filed three amended returns for 1973 reporting various changes in the amount of their net operating loss for the year, the only adjustments to the bad debt deduction for 1973 were reductions in the amount of that deduction (Pet. App. A30-A31). See Pet. 8-9.

[2] An application for a tentative carryback adjustment and refund does not constitute a claim for credit or refund. 26 U.S.C. 6411(a).

The Internal Revenue Service concluded that petitioners' refund claims were untimely. Petitioners then brought this action for a refund in federal district court.

2. The district court concluded that petitioners' refund claims for 1967 and 1970 were barred by the statute of limitations (Pet. App. A25-A66).[3] Petitioners' refund claim for 1970 resulted from carrying back to that year the net operating loss they incurred for 1973. Section 6511(d)(2)(A) of the Internal Revenue Code, as then in effect, provided (26 U.S.C. 6511(d)(2)(A) (1976)):

> If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback * * *, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th day of the 40th month (or the 39th month, in the case of a corporation) following the end of the taxable year of the net operating loss * * * which results in such carryback * * *.

The court concluded that, under this provision, the time for petitioners to file a claim for refund of an overpayment attributable to a net operating loss expired 38 1/2 months after the end of the year in which the net operating loss was incurred (Pet. App. A61). The year of the net operating loss (the loss year) in this case was 1973, and the limitations period prescribed by Section 6511(d)(2)(A) for filing a refund claim for petitioners' overpayment for 1970 therefore expired 38 1/2 months after December 31, 1973—on March 15, 1977.

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[3] Petitioners also sought a refund for 1973. The parties agreed that the 1973 refund claim was timely and that petitioners were entitled to a refund of $20,918 for that year (Pet. App. A67-A68). The 1973 refund claim is therefore not involved at this stage of the case.

The court further concluded that petitioners' 1967 refund claim was controlled by the separate rule provided in Section 6511(d)(4)(A) of the Code, 26 U.S.C. 6511(d)(4)(A) (1976) (Pet. App. A61). That statute established a limitation period for corporate taxpayers of 38 1/2 months after the close of the loss year "with respect to any portion of an investment credit carryback from a taxable year attributable to a net operating loss carryback * * * from a subsequent taxable year." 26 U.S.C. 6511(d)(4)(A) (1976). The time provided by Section 6511(d)(4)(A) for filing petitioners' refund claim for 1967 (which was attributable to the carryback to 1967 of 1970 investment credits freed up by the carryback to 1970 of the net operating loss incurred in 1973) also expired on March 15, 1977. Since petitioners did not file their refund claims for 1967 and 1970 until September 15, 1977, the claims were barred by these statutes of limitations (Pet. App. A61, A63).

The district court rejected petitioners' contention that the period of limitations applicable to the filing of their 1967 and 1970 refund claims was the 7-year period for filing refund claims arising from the carryback of losses from bad debt deductions under Section 6511(d)(1) of the Code, 26 U.S.C. 6511(d)(1) (1976). That Section states (*ibid.*):

> If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of * * * a [worthless] debt * * * has on the application to the taxpayer of a carryback, the period shall be * * * 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback * * *.

The court concluded that the 7-year period provided in Section 6511(d)(1) of the Code is available only when the

fact that bad debt deductions were understated was discovered after the date the original return was filed for the year of the claimed bad debt deduction (Pet. App. A46-A49). Petitioners were not entitled to the benefit of a 7-year limitations period under Section 6511(d)(1) because they knew of all of their 1973 bad debt deductions before they filed their original tax return for 1973 and the subsequent adjustments to their bad debts claimed for 1973 all *reduced* the amount of that deduction. The court noted that its interpretation of these statutes was consistent with the IRS's longstanding administrative rulings (Pet. App. A59-A61, citing Rev. Rul. 55-523, 1955-2 C.B. 497).[4]

3. The court of appeals affirmed (Pet. App. A1-A24). The court explained that the special 7-year limitations period of Section 6511(d)(1) applies to taxpayers who determine *after* filing the return for the year of the net operating loss that they should have taken bad debt deductions (or have understated their bad debt deductions) for that year (Pet. App. A20-A21). The court of appeals concluded that petitioners' claims for refund were governed by Section 6511(d)(2) and (4) of the Code and were therefore untimely (Pet. App. A21).

ARGUMENT

The decision below is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. Petitioners seek to recover refunds of alleged overpayments of income taxes for 1967 and 1970. For the

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[4] The district court also rejected petitioners' alternative argument that their claims for refund of 1967 and 1970 income taxes were timely by reason of petitioners' consent to an extension of the time for the assessment of certain excise tax liabilities incurred in 1973 (Pet. App. A62-A66). Petitioners have not raised this issue in the petition for a writ of certiorari.

district court to have jurisdiction over these claims, they must have been filed within the period provided by the applicable statutes of limitations. See *United States* v. *Dalm*, 494 U.S. 596, 602 (1990). The dispute in this case concerns which of two statutes of limitations governs the filing of petitioners' claims.

The courts below correctly held that, under the plain language of Sections 6511(d)(2)(A) and 6511(d)(4)(A) of the Code, since petitioners filed their refund claims arising from net operating loss carrybacks and credit carrybacks *after* the 38 1/2-month period provided by those Sections had expired, the district court lacked jurisdiction in this case (Pet. App. A21, A61). Petitioners assert, however, that the limitations period of those provisions is qualified by Section 6511(d)(1), which provides a 7-year statute of limitations for certain loss-carryback refund claims attributable to bad debt deductions. Petitioners claim (Pet. 14-26) that their 1967 and 1970 refund claims come within Section 6511(d)(1) because included among their 1973 deductions was a bad debt deduction larger in amount than their net operating loss for the year.[5]

As the courts below held (Pet. App. A17-A21, A61), however, to qualify for the extended 7-year limitations period of Section 6511(d)(1), more is required than merely having a net operating loss carryback to which a bad debt deduction contributed. Section 6511(d)(1) applies to a claim for refund for a carryback year only when the net operating loss was created (or increased) by a discovery made *after* the original return was filed that a debt had become worthless during the return year. The

---

[5] Petitioners' deductions in 1973 totaled approximately $149 million (Pet. App. A28). Petitioners' 1973 net operating loss of $4 million existed because their 1973 income was less than the sum of *all* their 1973 deductions, including their $6 million bad debt deduction.

House Report on these provisions explained that Section 6511(d)(1) was needed to protect a taxpayer for whom "[l]ater evidence" disclosed a miscalculation about the year in which a debt became worthless (H.R. Rep. No. 2333, 77th Cong., 2d Sess. 44-45 (1942), cited at Pet. App. A13-A14). The Internal Revenue Service has long interpreted the statute to have precisely this meaning (Rev. Rul. 55-523, 1955-2 C.B. 497). The agency's interpretation is entitled to substantial deference. *E.g.*, *Davis* v. *United States*, 495 U.S. 472, 484 (1990); *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132, 144 (1989); *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476-477 (1979).

The 7-year limitations period of Section 6511(d)(1) does *not* apply where the amount of the bad debt deduction that was reported in the original return either decreases (as in this case) or remains unchanged. If the amount of the originally reported bad debt deduction is reduced or stays the same, then the decrease (or lack of change) in the bad debt deduction does not create or increase the loss that the taxpayer is already entitled to carry back. Section 6511(d)(2) of the Code provides a specific period of limitations for refund claims relating to the carryback of net operating losses in general, including net operating losses to which bad debt deductions have contributed. It is only when a bad debt is discovered *after* the filing of the return for the year in which the debt became worthless that the special 7-year period of Section 6511(d)(1) applies.

Even if Section 6511(d)(1) of the Code were ambiguous in this regard, as a statute of limitations that conditions the government's waiver of sovereign immunity, it is to be strictly interpreted in favor of the sovereign. See *United States* v. *Nordic Village, Inc.*, 112 S. Ct. 1011, 1014-1015 (1992); *United States* v. *Dalm*, 494 U.S. at 608. The ambiguity that petitioners contend exists in the

statute does not provide a basis for a conclusion that sovereign immunity has been waived. See *United States* v. *Nordic Village, Inc.*, 112 S. Ct. at 1016.

For these several reasons, the court of appeals correctly concluded (Pet. App. A21) that Section 6511(d)(1) is not applicable on the facts of this case.

2. Petitioners err in contending (Pet. 57-64) that the decision of the court of appeals conflicts with the decision of the Court of Claims (now the United States Court of Appeals for the Federal Circuit) in *Smith Electric Co.* v. *United States*, 461 F.2d 790 (Ct. Cl. 1972). In *Smith Electric*, the Court of Claims permitted the taxpayer's refund claim for a carryback year to proceed under the 7-year limitations period of Section 6511(d)(1) even though the only bad debt deduction involved had been reflected in the taxpayer's original return for the loss year. 461 F.2d at 791. But in *Smith Electric*, the court did not address or decide the issue presented in this case. Instead, as the court noted in *Smith Electric*, *id.* at 791 (emphasis added; footnote omitted):

> The *sole* issue in this case is whether the special seven-year statute of limitations, with respect to filing claims for refund on account of the deductibility of a worthless debt, is applicable to taxpayers on the reserve method as well as to those on the direct charge-off method.

As the district court (Pet. App. A59) and the court of appeals (Pet. App. A14 n.3) stated, the decision in *Smith Electric* did not address or decide—and thus creates no conflict on—the issue presented in this case.

The precise question presented in this case *was* presented to, and decided by, the Court of Claims in *Armstrong* v. *United States*, 681 F.2d 774 (Ct. Cl. 1982). In *Armstrong*, as in this case, the taxpayers reported a net operating loss (to which a bad debt deduction had con-

tributed) in their original return for 1975, but they failed to file claims for refund for the years to which that loss could be carried back until after the period prescribed in Section 6511(d)(2)(A) of the Code had expired. 681 F.2d at 775, 776. The taxpayers in *Armstrong* nevertheless argued—as petitioners do here—that their refund claims were timely under the 7-year period of Section 6511(d)(1). 681 F.2d at 776. The Court of Claims rejected that contention (*id.* at 776-777):

> It would certainly appear that Congress did not have plaintiffs' situation in mind when the special bad debt limitation section was first enacted. The 7-year period was designed to prevent possible prejudice to those taxpayers whose otherwise legitimate deduction might be placed in jeopardy by the general 3-year period. No such risk extends to a taxpayer whose bad debt deduction is taken on the original return for the year. Congress was attempting to prevent a possible injustice, not simply providing an extra 4-year grace period for dilatory taxpayers.

The Court of Claims concluded that Section 6511(d)(2)(A), not Section 6511(d)(1), governs in this situation (681 F.2d at 778; footnote omitted):

> [T]he alleged overpayments * * * are not "on account of" the deductibility of a bad debt—plaintiffs took a bad debt deduction in 1975 which has not been contested. Rather, plaintiffs' overpayment resulted from the failure to utilize the NOL carryback provisions (section 172) within the time allotted under statute. The proper provision to be considered, then, is the NOL limitation period specified in section 6511(d)(2)(A), not the bad debt limitation period of section 6511(d)(1).

The decision in this case is therefore consistent with the Court of Claims' decision in *Armstrong* and does not conflict with that court's earlier decision in *Smith Electric*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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